TAX RELATIONS AMONG GOVERNMENTAL UNITS

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FOREWORD

THE most pressing tax problems of to-day arise out of the complexity and confusion of intergovernmental tax relationships. The Federal Government, 48 state governments, and some 175,000 local tax-levying units are in a condition of confused relationship both as to functional administration and the raising of revenues.

The old theoretical ideal of having each unit of government raise the revenues necessary for the maintenance of the functions which it administers is naive and outmoded, inasmuch as it clashes with the more modern concept that governmental functions should be assigned to those units which can most efficiently perform them, and that taxes should be levied by governmental units capable of assessing and collecting them effectively. A practical application of this theory means that subordinate units find themselves in the position of having to administer more functions than they can finance by means of the levies which they find it possible to utilize effectively. This situation necessitates the granting of financial aid on the part of larger units to subordinate ones.

So far in this country we have developed neither the theory nor the administrative technique to cope with this situation. The problem is aggravated by the extravagant number of small governmental units which can be justified by nothing more plausible than tradition and local vested interests, and by the imperfect distribution of functions from the standpoint of the criterion previously mentioned.

The Tax Policy League considered this problem to be of

such gravity that it devoted its 1937 symposium to it. A program committee consisting of Mabel Newcomer, Tipton R. Snavely, and myself as chairman, and with Harold S. Buttenheim and Mabel L. Walker acting in an *ex officio* capacity, outlined a list of topics to be considered at the symposium and selected for their treatment a number of specialists who have long been giving serious thought to these problems.

We believe that this collection of thoughtful and provocative addresses constitutes a valuable approach to a relatively neglected and increasingly critical phase of public finance.

SEABURY C. MASTICK,
Chairman,
Program Committee

PART ONE

FEDERAL STATE TAX RELATIONS

CHAPTER I

APPROACHES TO THE SOLUTION OF FEDERAL-STATE TAX CONFLICTS

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FROM the point of view of constitutional law, government in America is a duality, consisting of, first, the Federal Government and, second, the 48 states, each of which has a definite sphere of sovereignty which it must maintain by taxes.

But from the point of view of the taxpayer, government is a trinity, involving Federal, state and local authorities, and taxes are due to each. One Federal Government, 48 state governments, and approximately 180,000 local governments, are demanding support from the taxpayer.

Prior to the World War, the total demands made by these three authorities did not exceed 10 per cent of the national income, and, consequently, questions of conflict had relatively less importance. Today, under an expanded governmental program, the cost of government is about 25 per cent of the national income, and the taxes actually paid about 20 per cent, and, as a result, conflicts in taxing principles and methods among these various authorities are becoming an onerous burden.

It must never be forgotten that as taxes increase in complexity, the cost to the taxpayer of ascertaining his tax burden also increases, and this indirect result adds tremendously to the dissatisfaction of the taxpayers.

Recently, the Curtis Publishing Company, in response to a request, gave me the following information:

> In 1927, in order to do business in the United States, the company was required to file 14 reports with the various governmental authorities of the United States, and the preparation of these reports cost $850. In 1937, including social security returns, the company was obliged to file 44,610 governmental returns, and the cost of preparing the same was $21,100. In 1927 one of these returns was filed in Canada. In 1937 there is still one return to be filed in Canada.

This tremendous increase has taken place in the United States alone.

The taxpayer is fast becoming conscious of this situation and, as a result, he is becoming aroused. The American people have become tax-conscious and they will not be satisfied until there is some simplification in the methods of taking the tax money. Judge Leser of Baltimore told the National Tax Conference recently of a culprit who was brought before the Court on the charge of drunkenness, and when the Judge asked him if he was drunk, he replied: "In what degree?" "Why," said the Judge, "are there degrees in drunkenness? This is a simple question of fact." "Of course there are degrees in drunkenness," replied the culprit. "Was I verbose, jocose, or morose? Was I lachrymose, bellicose or comatose?"

Now the taxpayer has certainly reached the stage where, having been lachrymose, he has become bellicose, and it is a very good sign that this stage has been reached, because the next stage is comatose, and that we would seek to avoid.

A paper on "Solution of Federal-State Tax Conflicts From the Theoretical Point of View", was to have been presented by Dr. Robert Murray Haig of Columbia University, who is well recognized as one of the leading thinkers of the country in the field of taxation. Dr. Haig has been

prevented from being with us, and I should like to fill his place for a few minutes.

If Dr. Haig were here, he would call your attention to the fact that last year he was granted a six months' leave from Columbia University in order to study the tax system of Australia, that in Australia he found six states and a federal government, all of which imposed the income tax. But when after the War it became necessary for the states to enter into this field, there was widespread complaint on the part of the business interests of Australia that while they were perfectly willing to pay an income tax, they were not willing to have two sets of returns, two sets of reports, and two kinds of taxation. They therefore insisted that the federal government and the states must synchronize their programs.

As a result, in Australia there are five states in which the federal government alone collects the income tax, setting aside a portion of the return for the state governments, and there is one state in which the state collects the income tax for both the federal government and itself. In this way a proper revenue is collected, but the taxpayer has the burden of but one report, and the administration therefore is simplified. This results in the saving of cost by the tax collecting authority, and the saving of cost to the taxpayer in determining his tax liability.

This is the Australia plan, and it suggests whether this plan cannot be applied in the United States.

Dr. Haig might very well have also stated that in Argentina there are ten provinces and a federal government, that two years ago the entire problem of correlation was worked out in Argentina whereby income taxes and sales taxes and other general taxes are imposed and collected by the federal government with an apportionment of the proceeds to the states.

What Australia and Argentina have done has been proposed for the United States in what is known as the Graves-Edmonds Plan of National Taxation. This plan recognizes that simplification is a necessity in the United States, and proposes that where both the Federal and the state governments have an equal constitutional right to impose taxes, these taxes shall be imposed and collected by the Federal Government and the proceeds shared between the Federal Government and the states on some equitable basis. For instance, take gasoline, on which there is a Federal tax and also state taxes in every state, and sometimes local taxes. There are fewer than 500 refineries in the United States. If the Federal Government collects this tax, it has about 500 outlets to watch. But there are many thousands of gasoline distributors and vendors throughout the states. I have seen it estimated that in Pennsylvania alone there are 80,000 vendors of gasoline. If the state government imposes the tax, it must of necessity employ a large group of inspectors, and their inquisitorial visits affect both the poor and the rich, causing constant turmoil and confusion.

Why not impose a Federal tax of 4 cents, one-half of a cent to be retained by the Federal Government and the balance to be returned to the states, provided the states impose no tax on gasoline for themselves? All the state cost of collection would be saved, and there would be an ample revenue for each of the states if an equitable basis of apportionment could be found.

Mr. Graves and I have suggested in our plan that the apportionment to the states be one-third on the basis of population, one-third on the basis of motor registrations, and one-third on the basis of improved mileage of roads, and on this basis most of the states would receive as much as they do now from their state taxes, but there would be a

tremendous saving in the cost of collection and in the cost to the taxpayer.

The same principle could be applied to cigarette taxes and to income taxes and to liquor taxes and to other forms of taxation in which the nation itself is better fitted to do the work of collecting than the states, although the states have a just claim for a portion of the revenue.

CHAPTER II

INFLUENCE OF FEDERAL-STATE TAX COORDINATION ON FEDERAL FISCAL POLICIES

CARL SHOUP

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FROM the point of view of its own fiscal program the Federal Government has certain incentives to assist in the development of Federal-state tax relations. It is the purpose of this paper to outline some of the more specific reasons for this interest and to recall briefly some of the ways in which it may be translated into action.

In the first place, as the past few years have clearly revealed, the magnitude of the task that the Federal Government faces will henceforth depend largely on the fiscal health of the states. If they must operate under a tax-raising machinery that is crippled by jurisdictional conflicts, expensive administration and undue restriction on use of various tax sources, the states will exert correspondingly more pressure on the Federal Government for funds. There are doubtless sound reasons for Federal aid to the states under certain circumstances, but whether the circumstances are themselves undesirable and, if so, whether they can be removed must also be considered. Federal aid neces-

[1] On leave as Assistant to the Secretary of the Treasury as this is written; but the analysis is that of the individual writer and is not an official statement of a Treasury program. This paper was not delivered at the Tax Policy League's Conference, but was written (before access to the papers delivered there) at the League's request for a brief statement of Federal aspects of tax coordination.

sitated, paradoxically, by lack of Federal-state coordination is scarcely a credit to either the donor or donee.

In the second place, even if the Federal Government were not called upon to aid the states, it would find tax coordination desirable in order that its own revenue program might not be disturbed. Probably no one state is in a position to disturb the Federal program seriously, but states have shown a tendency to move together in some phases of their tax development.

Effect of State Levies on Federal Taxes

The Federal tax that is affected in the greatest number of ways by state action is the income tax.

Every time a state increases its income tax rates it decreases the Federal Government's tax revenue slightly, since state income taxes paid are allowed as deductions in computing net income subject to Federal tax. Any state that adopts a community property law decreases Federal income tax revenues. If a state makes a retail sales tax or a gasoline tax an obligation of the consumer rather than merely of the seller, there is an increase in the deductions taken in Federal income tax returns for "taxes paid." To the extent that a state or locality pays as it goes, by certain kinds of taxes, instead of borrowing, it tends to substitute an immediate, substantial deductible item (taxes) for a series of future small, deductible items (taxes levied to defray interest). But to the extent that it borrows and spends in place of not borrowing and not spending, the net result may be a decrease in Federal income tax revenues because the increased supply of tax-exempt bonds tends to lower their price and increase their use as means of avoiding tax. Expansion of state functions sometimes increases the number of persons exempt from Federal income tax. Duplication of audit and assessment may create so much

resentment among taxpayers that administration of the Federal tax may be seriously hampered. Non-fiscal measures by the states may likewise have important repercussions on the Federal income tax. For example, state laws regulating the distribution of dividends have affected the operation of the undistributed profits tax. Some of these income tax items, and others not included here, are minor in themselves, but they indicate how many points of contact one system has with the other.

Federal estate and gift taxes are directly affected by state action (fiscal and non-fiscal), even without considering the crediting device.

The longer the time for which property can, under state laws, be tied up in trust, the greater is the loss to the Federal Government in gift tax and estate tax revenues, at least under the existing Federal law. Like the income tax, the Federal estate tax suffers when a state adopts a community property law. The charges allowed against an estate by state law, as in the support of dependents during administration of the estate, determine in large part the size of the deductions allowed in the Federal estate tax return. By imposing gift taxes, states affect the Federal revenues; insofar as the state taxes tend to check gifts the result is a decrease in Federal gift tax revenues but probably an increase in Federal income tax revenues (since an income split among several persons usually pays less income tax) and possibly, but not necessarily, in Federal estate tax revenues.

States' taxes on transfer, especially on stocks and bonds, may affect appreciably the revenues from the Federal stock and bond transfer taxes by restricting the volume of sales. Similarly, further use and more intensive use of the cigarette tax by the states might decrease substantially the Federal Government's revenue from its own cigarette tax, owing to

a decline in physical sales volume as a result of the higher prices necessitated by the new state taxes. The Federal Government must consider any changes in its liquor tax laws in the light of existing state laws on the same subject, and no doubt the Federal Government's campaign against bootlegging has much less flexibility than it would have if no states taxed liquor. The fact that nearly half the states impose the sales tax makes the manufacturers sales tax somewhat less available for the Federal Government than it otherwise would be (all this without any implications of the merits or demerits of such a tax).

Finally, considering their tax systems as a whole, the states are tapping the same general economic resources as the Federal Government.

Possibilities of Federal Action without State Action

Since more coordination is needed, what are the possibilities that the Federal Government may achieve it to some degree without waiting for state action, and, for coordination beyond this point, what are the possible mechanisms for getting joint Federal and state action?

Further use of the crediting device, which is now employed with the death tax and the payroll tax on employers of eight or more, raises some important questions for Federal fiscal policy. To some extent this device may represent a real sacrifice of revenue—that is, the Federal Government might find it feasible and desirable to levy the same rates without the credit as with the credit. In other cases the sacrifice may simply be one of bearing the responsibility for the height of the tax rates, or for the tax itself—that is, the rates that the Federal Government would levy in connection with a crediting device might be higher than it would think feasible if no such device was used, or it might not levy the tax at all if the crediting device was not avail-

able. In this case there may be little or no actual revenue loss to the Federal Government, but the rate schedule or the tax may be regarded as a Federal schedule or tax and some misunderstanding as to complete responsibility for the tax may ensue. These considerations may indicate some of the possible limits to the Federal Government's willingness to extend the crediting device, especially on a piecemeal basis without simultaneous advances in other fields of Federal-state tax coordination.

While the use of the crediting device could conceivably be extended by unilateral action by the Federal Government, any development of the separation-of-sources approach of course involves, in practice, some sort of prior agreement between the Federal Government and the states. Aside from minor taxes that are not significant for the present problem, there is obviously no tax that the Federal Government is in a position to relinquish entirely without knowing what the states will be willing to do in return. Moreover, current revenue needs indicate that in any case it would be very difficult for the Federal Government to give up any of its major sources. Certainly no one would expect it to relinquish the income taxes, the customs duties, or the liquor taxes, and probably few would by now expect it to abandon the death tax and gift tax. These taxes, however, account for three-quarters of the Federal tax revenue aside from the social security taxes, or, to put it another way, if these sources are not to be "separated,"[2] there remains only about a billion or a billion and a half dollars of tax revenue (social security taxes aside) that might be considered for separation, and many of the taxes in that residual group are, it would seem, not likely to be

[2] Except the customs duties, which are, of course, already the exclusive property of the Federal Government.

abandoned by the Federal Government under any plan of coordination.

Federal administration of a tax with return of the money to state of origin (which may be defined here as the state that would have gotten the money if it had administered the tax itself) is a type of coordination that, prima facie, at least, has no decisive disadvantages for the Federal Government. Obviously, however, much depends on what further exploration of the subject develops. Although the use of this device calls for something more than unilateral action, the Federal Government might be able to make up its mind, without waiting for the states to formulate their programs, on whether it was willing to enter into such an arrangement.

If the rate of the tax is fixed by the Federal Government and is therefore uniform throughout the country, the device just noted develops into much more of a centralizing mechanism, even if the tax proceeds (or the state part thereof) are still returned to the state of origin. The Federal Government is then called upon to consider directly—not simply indirectly, as at present—what the state's fiscal needs are when it decides upon a Federal tax rate. Whether such a great responsibility should be undertaken by the Federal Government is a fundamental question of intergovernmental relations that has important implications far beyond the taxing field. While the crediting device under the death tax and payroll tax also tends to determine the states' tax rates, a direct setting of the rate would represent a substantial change in the current philosophy of Federal-state relations.

If the proceeds of the tax are turned over to the states on some basis other than origin, the coordination touches directly on some fundamental problems of the expenditure and debt relations of the Federal and state governments.

There are many possible bases of distribution—for example, the simple per capita basis or some refined and complex combination of ability and need—and there are many degrees of control that the granting unit can exercise over the receiving unit, ranging from practically no control at all to a high degree of supervision over the use of the money for a carefully specified purpose. Sometimes the control may take the form of inducement, as in stimulative matching grants, but under this plan the granting unit must usually get the money from its general revenue rather than from some specified tax, since the amount to be given will fluctuate independently of the yield of any tax.

These considerations indicate that the Federal Government should not move toward a long-term coordination by means of grants (whether from a specified tax or from general revenues) simply as a way to avoid tax conflicts. Many other important issues are involved.

In summary, then, of the possibilities that the Federal Government might achieve some coordination without waiting for state action, it appears, first, that the Federal Government should feel a considerable incentive to do as much as it could in this way but that practically it finds the possibilities appreciably limited. The question then arises concerning possible mechanisms for getting joint Federal and state action.

Here it may be useful to distinguish between what may be called a restricted approach and a comprehensive approach. This paper does not advocate one as against the other, but it may be helpful to realize the necessity for making a choice between the two or at least of setting up different mechanisms to deal with them.

The restricted approach can probably best concern itself with administrative problems. A priori, there seems no insuperable bar to experimenting piecemeal with joint or

single administration of a given tax, perhaps only in a given state or states. Suggestive patterns have been developed in other countries, as in Australia and, in the form of local rates on national tax bases, in certain European countries. If some such experiment seemed desirable, perhaps in the preliminary stages it could be planned largely by informal conferences among Federal administrators and the administrators of the states that are particularly eager to try such a device.

The comprehensive approach, on the other hand, must not only go beyond the administrative aspects of the tax conflict, but must go beyond the tax conflict itself and become a study of fiscal conflict, thus embracing problems of expenditures and debt. An attempt to describe the precise mechanism that should be developed to work on this problem is beyond the scope of the present paper. However, this problem is so fraught with special-interest sub-problems (legitimate enough, of course) that the most practicable way would seem to be to constitute a committee [3] whose members would not directly represent any special interest—particularly the special interests of the Federal Government or of any state or local unit—but who would give full hearing to such interests and be able to understand sympathetically their aspirations in order to blend them into a general plan of wide scope that would promise enough benefit to each to be acceptable to all.

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[3] As suggested by Professor Robert M. Haig at the opening session of the Second Interstate Assembly, February 28, 1935, in *The Book of the States,* 1935, pp. 312–13.

CHAPTER III

SOLUTION OF FEDERAL-STATE TAX CONFLICTS FROM THE STATE POINT OF VIEW [1]

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ONE of the costs of a federal system of government such as we enjoy in the United States is some measure of conflict in the tax system. The advantages doubtless justify the expense. It is not reasonable to expect that tax measures in each of the various states be uniform, even though they originate currently. The failure to dovetail is made more certain by the fact that our state tax systems had their origins in an era during which business and industry were confined to individual localities and were not, therefore, very much concerned with any situation that might exist in another state.

The problem as between states on the one side and the Federal Government on the other is not very different, and the historical factor is even more pronounced. The Federal tax system, until the period of the last two or three decades, was substantially separated from the tax systems of the states in that revenues were derived almost exclusively from a few selected excises and from custom duties; whereas state governments did not employ extensively either of these revenue devices. Developments of

[1] It has been my pleasure to discuss somewhat the same subject matter elsewhere in more detail. See "Tackling the Conflicts in Taxation," *Tax Magazine*, May, 1935, and *Conflicting Taxation*, Chaps. II and IX.—J. W. M.

the period during and since the World War have resulted in large-scale utilization by state and Federal governments alike of the same and similar tax measures; [2] and the situation resulting, in the light of historical background, was certain to bring with it a large measure of interjurisdictional difficulty.

The situation with which tax students in the United States are confronted is therefore one which involves jurisdictional conflicts on two primary levels. The first is between the Federal Government and the state governments. The second is between different state governments. Both classes of conflicts entail substantial additional cost of tax administration, both for the public and for taxpayers. It will be helpful, then, to examine the possibility of a constructive attack on Federal-state conflicts.

It may not be amiss to suggest at the outset that the difficulties incident to Federal-state conflicts, great as they are, have been seriously exaggerated in respect of certain particular problems. Ordinarily the fact that two levies are imposed on the same base does not introduce any conflict. For example. a city and a county may each levy a property tax; and, in the absence of conflicting administrative arrangements, there need be no greater irritation to taxpayers and no more difficulty of administration than if the city alone imposed a levy equal to the aggregate rate actually imposed by the city and county combined. The same situation exists as between the Federal Government and the states. The fact that two separate jurisdictions levy taxes on the same base, however, is likely to cause difficulty for the reason that each jurisdiction may impose its levies without adequate regard to the action

[2] The extent of duplication is examined in Martin, "Trends in Federal-State Taxation Relationships," *Southern Economic Journal,* July, 1936.

of the other. Thus the rate at one point may be excessive and at another insignificant.

To illustrate this situation further, attention may be directed to discussions of the Federal and state gasoline and cigarette taxes. The two governmental levels impose cigarette taxes in such a manner that often there is partial duplication of the cost of stamping, but no other serious conflict, and the conflicts between gasoline taxes imposed by the states and those imposed by the Federal Government are not serious except as the duplication may result in excessive rates. There are no great procedural difficulties introduced for either taxpayers or tax administrators by reason of having both a Federal and a state gasoline tax—however unwise the duplication may be on economic grounds.

Outstanding Conflicts

It is important, in order to clarify the attack on conflicting tax difficulties, to set out what seem to be some of the most important problems to be confronted and then outline methods of approaching a solution. Probably the most fundamental difficulty of all results from the doctrine of reciprocal immunity introduced in malignant form by the decision of Mr. Chief Justice Marshall in the case of *McCulloch v. Maryland*. It is apparent from Mr. Chief Justice Marshall's logic that no state should be permitted to undermine the Federal Government by means of discriminatory taxation. It is not at all apparent that general applications given the doctrine of reciprocal immunity are necessary to protect our Federal Government from the states or our state governments from the Federal Government. Indeed, no such extensive application of the doctrine of immunity has characterized federal governments

aside from the United States.[3] Whatever may have been the reason for the doctrine of reciprocal immunity, the situation now existing is one of greatest moment both to the Federal and to the state systems; but the difficulties for the states are distinctly more serious than those for the Federal Government on legal grounds and because of the state's restricted area.

The states' problem is enhanced by the legal logic which has interpreted Federal immunity from state taxation to include so much more territory than does state immunity from Federal taxation. The Supreme Court has recently held, for example, that a state may not tax the salary of an employee of the Panama Railway, a federally owned railroad. The same court also held that the Federal Government may tax the *income* to a state derived from a state liquor monopoly, although the monopoly was devised primarily to regulate the liquor industry and only incidentally to raise revenue. The general rule, in fact, has been developed that the doctrine of reciprocal immunity does not protect a state from taxation insofar as the state engages in an industrial or commercial enterprise; whereas the doctrine does protect the Federal Government from taxation irrespective of the particular activities of the Federal Government concerned. The discriminatory application of the doctrine is distinctly obnoxious to those concerned with state tax policies; it does not appeal to a practical-minded citizen's sense of fairness, however defensible it may be from a legal point of view.

As has been frequently set out, the conflicts between the Federal and state income and death taxes are among the most serious in our entire system. Since 1926 the difficulties have been greater as between income taxes than as

[3] Adarkar, *Principles and Problems of Federal Finance,* pp. 48 ff.; Moore, *Commonwealth of Australia,* pp. 421 ff. and 519 ff.; and *Abbott v. City of St. John,* 40 S.C.R. 597. See also references in Footnote 6, Chapter IV.

between death taxes, but the 1926 legislation by no means definitively dealt with the problems of inheritance and estate tax conflicts. Among the most serious problems incident to Federal and state income taxation are diversity of application, which is probably less than it should be under the circumstances as respects reciprocal immunity and other restrictions on the state taxing power; lack of adequate interchange of confidential information; confusion on the part of taxpayers concerning the use of forms by Federal and state governments; and rate inequalities arising from failure to dovetail state and Federal levies.

Much the same difficulty, though somewhat less pronounced, occurs in the case of death taxes. The 1926 crediting provision of the Federal estate tax introduces some additional problems for the commonwealths, particularly an uneconomical suggestion that the state rate policy should conform with the credit enjoyed under the Federal law. Such a rate structure is unsound, mainly because the credit available to the state is insignificant in the case of small estates where on economic grounds it should be large, and substantial in the case of larger estates where on economic grounds it should not be proportionately so large.

For the most part, as suggested already, the direct conflicts between Federal and state gasoline, tobacco and other excise taxes are comparatively unimportant in themselves. Certain difficulties involving diverse exemption provisions and unusual applications do occur, but these are minor. The grave problems of the states arising from the relationships between themselves and the Federal Government occur in connection with the exemption necessitated by the doctrine of reciprocal immunity. One serious current problem, for example, is that of administering state excise taxes in the face of Federal exemptions, particularly as

applied to certain semi-official activities of the Federal Government. Perhaps the most objectionable illustration is found in respect of commodity sales subject to state excise tax to post exchanges of the Civilian Conservation Corps. The method of handling the business of these enterprises, generally construed by state governments to be in the nature of voluntary associations, is such as not to afford tax administration even the protection that sales through the regular procurement service of the Federal Government are given. Thus, quite aside from the exemption of sales to C. C. C. post exchanges, Federal officials by insisting on this exemption introduce and maintain an inviting opportunity for the bootlegger. In Kentucky, for example, the State Attorney General holds that C. C. C. exchanges are subject to a number of the state excise taxes, but the Department of Revenue can not enforce collection for the reason that the exchanges are managed by army officers not subject to the jurisdiction of the state. The result is a modified state of anarchy which is intolerable. This is only one of the large number of specific problems in the administration of state excises incident to exemptions required under the doctrine introduced by *McCulloch v. Maryland.*

Conflicting alcoholic beverage taxes imposed by the state governments and the United States require little comment. The conflicts arise almost wholly from the fact that the aggregate rate is so high as to render effective regulation of the liquor traffic well-nigh impossible. The conflicts between the different tax measures themselves are comparatively unimportant; and the principal difficulty, aside from the effect on regulation, arises from the administration of exemptions necessitated by Federal immunity from state taxation.

In addition to these larger conflicts it may be suggested

that, throughout the tax system, reciprocal immunity causes a lack of dovetailing which is unsatisfactory to taxpayers in that exemptions from Federal taxes necessarily vary from those for state taxes; and taxpayers are ordinarily not aware of the abstruse legal reasoning supporting these variations.

Another matter, which, though minor in form, is of tremendous significance, is the over-emphasis in both state and Federal governments on the confidential character of information in respect to individual taxpayers. The fact that there is no free interchange of data between Federal and state officials as to particular cases impedes doing the administrative job. The situation in many instances requires that the same taxpayer's money be spent for making two investigations of his own business when he is reluctant to have even one.

Approach to the Solution of Federal-State Conflicts

Free interchange of confidential data between the Federal Government and the states, then, is urgently needed from the practical point of view. It is true, perhaps, that many of the states would not utilize the information; and, with notable exceptions, the Federal Government scarcely ever appears to rely on the results of state investigations. The extension of reciprocal relationship on this score would greatly relieve irritation to taxpayers and would render tax administration more effective.

In a few specific matters, it seems important to the states to seek Congressional assistance. An obvious case will illustrate this need. At the present time practically all the state income taxes attempt to tax all individual incomes, with certain specific exceptions. Salaries paid from the proceeds of grants-in-aid received by the states from the Federal Government are taxable in so far as the grant becomes

commingled with state funds, and non-taxable if segregated and so used. The law is impossible of application in practice, and it would seem that in a small matter of this sort Congress should authorize the taxation of salaries paid from all grants-in-aid irrespective of whether or not the funds have been commingled with state funds.

Also extremely important from the viewpoint of improving the Federal-state tax relationships is the maintenance by state tax administrations of close observation of Federal legislation and active participation in the hearings before congressional committees. If the states vigorously present their viewpoints in respect to tax matters on which they can agree, the results will undoubtedly be helpful. In order to do this effectively, certain developments now in process must be consummated. In the first place, there must be an integrated tax administration in each state which can be aware of problems on the one side and maintain contact with Federal developments on the other. It is not practical to meet the situation if the various commonwealths scatter tax enforcement among half a dozen administrative agencies. In the second place, maintenance of contact by state tax administrators with Federal legislation requires increased emphasis on organization of officials. Some beginning has been made in the recently developed Federation of State Tax Administrators. As yet, however, the strength of this organization is not such as to enable it effectively to present matters of this sort. An incidental third necessity, if we are to deal with the situation wisely, is enlightened leadership in matters of tax policy by the integrated state tax administrations. As has frequently been said, the technicalities of state taxation must be inspired largely by the administration; and, generally speaking, legislators are entirely willing to consider the view-

point of administrators in technical matters even though not, for example, in rate matters.

Another possibility of relieving the difficulty between state and Federal tax administration is for each to formulate rules and regulations in the light of what has already been done. In many matters state regulations ought not to be prescribed until a careful study has been made of Federal regulations on related subject matter. By this approach considerable difficulty for taxpayers oftentimes can be avoided.

Elimination of the deduction of Federal income taxes in computing state income taxes is another point at which improvement can be made. This deduction in ordinary cases simply means decreasing the state income tax rate, and does not mean any greater fairness of application. Allowing deduction in certain types of cases involves serious discrimination which can not be justified on any ground. The most serious objection, however, is that the deduction is extremely hard to compute; and the average taxpayer is unable accurately to take advantage of it. This fact introduces increased administrative cost as well as irritating effects on taxpayers.

In conclusion it may be suggested that dealing with conflicting taxation from the viewpoint of the states means merely dealing with conflicting taxation. Some of the effort must be put forth by the state administrators; some by Congress; some by the United States Treasury; and, perhaps most neglected of all, a great deal by the general public, especially by taxpayers doing business in two or more states. Both official and unofficial efforts to improve the situation in respect of conflicting taxation have almost uniformly ignored the necessity of taxpayer cooperation, and taxpayers have gloriously failed to provide effective aid or to invite cooperative effort from tax administrators.

In general the approach to a solution of the major difficulties seems to lie in continuous efforts directed toward relatively small matters, and not in an over-all attack on the comprehensive solution. Those who have favored separation of sources of state and Federal revenue, Federal administration with some distribution of revenue to the states, further use of the crediting device, and supplementary state levies incident to Federal taxes, have never suggested in concrete, workable form how any one of these solutions could be brought about in practice, and in all probability no feasible suggestion can be offered. The major line of attack, therefore, cannot wisely be directed toward this comprehensive solution. It must rather be trained on the specific, definite problems which can be dealt with, at least in part, by legislative and administrative action, and which will not arouse too vigorous opposition.

CHAPTER IV

RECIPROCAL IMMUNITY OF FEDERAL AND STATE INSTRUMENTALITIES

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HISTORICAL BACKGROUND

THE conventional approach to a discussion of this subject is a reference to that historical opinion of Chief Justice Marshall in the case of *McCulloch v. Maryland*[1] in which he laid down that far-reaching aphorism, "the power to tax involves the power to destroy." The enunciation of this maxim for the first time in 1819 is all the more striking when it is considered that the framers of the Constitution, although finding it necessary to place certain very definite limitations on the taxing power of both Federal and state governments, did not see fit to restrict the operation of this power by the one upon the other. The Constitution contains three express limitations upon the taxing power of the national government, namely: (1) that taxes shall be apportioned according to population; (2) that all duties, imposts and excises shall be uniform, and that no tax shall be levied on exports from any state; and (3) that no preference shall be given to the ports of the various states.[2] On the other hand, the states are specifically prohibited, without the consent of Congress, (1) from imposing duties on

[1] *McCulloch v. Maryland,* 4 Wheat. 316 (1819).
[2] Article 1. Sections 2, 8, 9.

imports or exports except for inspection purposes, and (2) from levying tonnage duties.[3] It is to be noted, moreover, that no reference to the problem is found in the discussions in the *Federalist*.

Two conclusions may possibly be drawn from the absence of any reference to this subject. First, the draftsmen and commentators of that day did not foresee that any such problem would arise. This conclusion, however, appears improbable in view of their omniscience respecting other matters. The second conclusion, and one which, it must be confessed, appears the more likely, is that the problem was foreseen and it was not considered undesirable that the taxing power of the one sovereign should operate upon the other.

Regardless, however, of what may or may not have been in the minds of the constitutional draftsmen, it is not to be denied that Chief Justice Marshall laid down a rule of law in that historic case as definite as any to be found written in the Constitution itself; a rule of law, which, unlike most rules of judge-made law, has not been regarded as subject to the limitation that the rule must fall when the reasons underlying its original pronouncement cease to exist. That there was ample reason in fact for the decision at the time cannot well be doubted. The states were deliberately setting about to destroy what was to them an obnoxious creature of an intensely nationalistic government, the Bank of the United States.

The courts were not long in extending the cloak of protection accorded by the McCulloch case to other Federal agencies.[4] It was not, however, until 1862 that the converse situation arose. In that year Congress attempted to

[3] Article 1. Section 10.

[4] *Osborne v. Bank,* 9 Wheat. 738; *Weston v. Charleston,* 2 Pet. 449; *Dobbins v. Commissioner,* 16 Pet. 435; *California v. Central Pacific R.R. Co.,* 127 U.S. 1; *Van Brocklin v. Tennessee,* 117 U.S. 151.

impose a stamp tax on state documents which were introduced as evidence in the state courts. The validity of such a tax was immediately questioned, the vast majority of state courts holding such an exaction invalid. But the first decision of lasting importance on this side of the ledger involved the application of the Revenue Act of 1867 to the compensation of a State Judge. The decision of the Supreme Court in that case, *Collector v. Day,*[5] received wide acclaim in the press of the southern states. Democratic papers throughout the land hailed it as a revival of respect for state rights which had been hurled into discard during those bitter days of the Reconstruction. It must be confessed, however, that the same cogent reason which impelled Chief Justice Marshall to deny Maryland's right to tax the Bank of the United States did not exist in the case of Judge Day. He was asked to do no more than other citizens of the United States in contributing his fair share toward the expenses of government. That the money with which to pay the tax came out of the proceeds of his office as state judge seems no sufficient ground for affording him such preferential treatment. But, regardless of the wisdom of that precedent, it paved the way for a long line of decisions in which the courts have laboriously attempted either to distinguish or to reconcile previous cases.

With this passing reference to the circumstances surrounding the birth of this Frankenstein of American jurisprudence [6] let us proceed to trace its development through a stormy adolescence to its present state of full-grown manhood.

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[5] 11 Wall 113.

[6] This doctrine is not, however, peculiar to the American system alone. See "*McCulloch v. Maryland* in Australia," 18 *Harvard Law Rev.*, 559, 571; Powell: "*McCulloch v. Maryland* in Canada and Australia," 31 *Mich. Law Rev.*, 797–803.

Direct Operation of Doctrine

This reciprocal immunity of instrumentalities and agencies of the state and national governments from taxation may operate directly or indirectly. Its operation is direct when it cloaks such instrumentalities or agencies themselves with immunity.

Instrumentalities of the Federal Government enjoy immunity from property taxation by state governments.[7] This immunity from state taxation was extended to include taxation by subdivisions of the states.[8] As a corollary, property of states and municipal corporations is to be treated as an improper subject of Federal taxation.[9]

That a sale to the United States is not subject to state taxation and, conversely, that a sale to a state is not subject to Federal taxation is apparently well settled. Immunity from Federal sales taxation is likewise extended to political subdivisions of a state.[10] The Supreme Court of California has recently held that immunity from state taxation extends to sales made to the Production Credit Corporation.[11] An attempt by Alabama to impose a kilowatt tax upon the generation of electric power at Muscle Shoals was denied.[12]

Few cases, if any, have involved an actual attempt either by a state to impose an income tax upon an instrumentality of the Federal Government, or by the Federal Government to impose an income tax upon an instrumentality of a state. Such taxation, it is believed, would be clearly invalid, certainly in the absence of Congressional permission.

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[7] *Van Brocklin v. Tennessee,* Note 4, supra.
[8] *Wisconsin Central Railway Co. v. Price,* 133 U.S. 493, 33 L. ed. 687.
[9] *U.S. v. B. & O. R.R. Co.,* 84 U.S. (17 Wall) 322, 21 L. ed. 597.
[10] *Indian Motocycle Co. v. United States,* 283 U.S. 570, 75 L. ed. 1277.
[11] *West v. Johnson,* Cal. 71 P. (2d).
[12] *Alabama v. U.S.,* 38 F. (2d) 897, reversed on other grounds, 282 U.S. 50; 75 L. ed. 492.

This immunity from Federal income taxation extends to political subdivisions of the state.[13]

Indirect Operation of Doctrine

1. Immunity of Governmental Obligations

Let us pass on from the direct operation of the immunity to its indirect operation. The instrumentality may be indirectly affected by taxation of its obligations; to a lesser extent, by taxation of its employees, and even to some extent by taxation of individuals who enter into contracts with it.

It was early held that obligations of the Federal Government were not subject to state ad valorem taxation.[14] This position has been so consistently maintained that it is now too well established to permit of doubt.[15] This same immunity attaches to bonds issued by municipalities in the Indian Territory.[16] Conversely, the Supreme Court has indicated that obligations of the state and its municipalities would be exempt from ad valorem taxation by the Federal Government.[17]

It appears that not only are the obligations of the Federal Government immune from state ad valorem taxation, but also that income therefrom is not subject to any type of taxation. It has been held that an excise tax measured by income cannot constitutionally apply to that income which is derived from Federal obligations (*Macallen v. Massachusetts*).[18] In view, however, of more recent decisions involving other excise taxes measured by income in which the courts held that the income from patents and

[13] *Jamestown & Newport Ferry Co. v. Commissioner,* 41 F. (2d) 920.
[14] *Weston v. Charleston,* Note 4, supra.
[15] *Home Sav. Bank v. Des Moines,* 205 U.S. 503.
[16] *Farmers & Merchants Bank v. Minnesota,* 232 U.S. 516, 58 L. ed. 706.
[17] *Pollock v. Farmers Loan & Trust Co.,* 157 U.S. 429.
[18] 279 U.S. 620.

copyrights could constitutionally be included in determining the tax liability,[19] and, furthermore, in the light of the recent decision of the Supreme Court in *Pacific Company v. Johnson*,[20] it is very doubtful that the decision in *Macallen v. Massachusetts* is still law. In the *Johnson* case it was held constitutional in fixing the franchise value of a corporation measured by net income to include the income from exempt securities. In a labored attempt to distinguish this from the *Macallen* case, the Court pointed out that the latter case involved a statute which specifically referred to the inclusion of income from Federal securities, and for that reason it was invalid under the decision in *Miller v. Milwaukee*,[21] which involved a tax measured by exempt income alone. The Court, in the *Johnson* case, reaffirmed its decision in *Flint v. Stone-Tracy Co.*,[22] which had been somewhat discredited as result of the *Macallen* case. As has been already stated, in the *Pollock* case the Supreme Court denied the right to include as income the interest from state and municipal bonds in determining liability under the Federal Income Tax Law. This cloak of immunity, however, does not extend to income derived as the result of transactions in tax-exempt securities. In the case of *Willcuts v. Bunn* [23] gain derived from the sale of municipal bonds not issued at a discount was held properly subject to the Federal income tax. The converse of this ruling, it is to be assumed, would apply in the case of a state income tax on the gain derived from dealings in Federal securities.

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[19] *Educational Films Co. v. Ward,* 282 U.S. 379; *Fox Film Corp. v. Doyal,* 286 U.S. 123.

[20] 285 U.S. 480, 76 L. ed. 893.

[21] 272 U.S. 713, 71 L. ed. 487.

[22] 220 U.S. 107, 55 L. ed. 389.

[23] *Willcuts v. Bunn,* 282 U.S. 216, 75 L. ed. 304.

2. Immunity of Governmental Employees

Justification for application of immunity to the agencies and instrumentalities themselves is susceptible of establishment. To a less extent this is true of obligations of the instrumentalities and agencies. Certainly, the efficient operation of a government is dependent to a large extent upon the maintenance of its credit. However, the extension of the immunity to include employees and independent contractors with the government presents a problem much more difficult of justification.

There appears absolutely no reason for saying that the property of an employee of the government or an employee of an instrumentality or agency of the government should be exempt from taxation by either jurisdiction. Never has immunity been extended to cover this situation. Likewise, there appears no reason for holding such an employee exempt from excise taxation. It is only in the field of income taxation that this doctrine of immunity has been permitted to run riot. We find the courts, both Federal and state, gasping for breath in a vain attempt to draw some definite line of demarcation between taxable and non-taxable compensation.

As has been pointed out, immunity of employees of the United States and of its instrumentalities and agencies from state taxation dates from the decision in *Dobbins v. Commissioners of Erie County.* It must be noted in passing, however, that the tax involved in that case was not an income tax, but, rather, was a tax upon the office measured by the gross proceeds therefrom. The correlative immunity of employees of the state, its instrumentalities and political subdivisions dates from the momentous decision in *Collector v. Day,* already referred to. This immunity, however, has not been extended uniformly to all employees either of the

national government and its instrumentalities, or of the state governments and their instrumentalities. Any court seeking the guiding hand of precedent finds itself face to face with appalling inconsistency. This inconsistency, however, is due in the main to an attempt to do lip service to *McCulloch v. Maryland,* and yet to bring relief from its illogical consequences by borrowing a principle from municipal tort law, i.e., the distinction between proprietary and governmental functions.

3. Immunity of Independent Contractors

Reserving until later a discussion of the distinction, if any, between governmental and proprietary functions, let us pass briefly to the law covering the tax liability of independent contractors with both the Federal Government and its instrumentalities and the state governments and their instrumentalities.

That the property of an independent contractor is not immune from ad valorem taxation is well settled. However, not until more recently was immunity denied him in respect of excise taxation. Independent contractors with the Federal Government are not exempt from the payment of a state gasoline tax,[24] of general sales taxes; [25] or of state use taxes.[26] They are not exempt from the payment of gross [27] or net income taxes.[28] This is true, even though the contract be one to carry the mail.[29] Likewise, an individual is subject to the Federal income tax upon gain derived from a contract with the state.[30] It follows, log-

[24] *Trinity Farm Construction Co. v. Grosjean,* 291 U.S. 466, 98 L. ed. 918.

[25] *Ryan v. State,* 61 P. (2d) 1276.

[26] *Henneford v. Silas Mason Co. Inc.,* 300 U.S. 577, 81 L. ed. 514.

[27] *Silas Mason Co. Inc. v. Tax Commission,* 82 L. ed. (adv.) 154; *James v. Dravo Const. Co.,* 82 L. ed. (adv.) 125.

[28] *Atkinson et al. v. State Tax Comm.,* 67 P. (2d) 161, affd. 82 L. ed (adv.) 440.

[29] *Alward v. Johnson,* 282 U.S. 509, 75 L. ed. 496.

[30] *Metcalf & Eddy v. Mitchell,* 269 U.S. 514, 70 L. ed. 384.

ically, also, that an employee of an independent contractor with the one jurisdiction is not exempt from taxation by the other. [31]

4. Immunity of Lessees

The problem of the lessee is somewhat closely related to the problem of the employee and the independent contractor. In the bitterly contested case of *Gillespie v. Oklahoma*[32] a divided court held that a lessee of restricted Indian mineral lands, title to which was in the United States, was exempt from the general state income tax on the ground that in taxing the income derived by the lessee from his share of oil and gas received from the leased lands the state was in effect taxing a Federal instrumentality. Apparently, though, what was sauce for the goose was not sauce for the gander. In *Group Number One Oil Corporation v. Boss* [33] the Court upheld the right of the Federal Government to tax a lessee of land title to which was in the state. The next year, however, the Court reverted to the view which would seem necessarily to follow from their holding in the *Gillespie* case. In *Burnet v. Coronado Oil and Gas Company,*[34] a Court, divided this time five to four, held the Federal tax inapplicable to the income derived from a lease of state lands dedicated to the support of schools, by which lease part of the proceeds from the oil and gas production was reserved to the state for its public school fund. On March 7, 1938, however, the Supreme Court again reversed its position, this time by a five to two decision, and overruled both the *Gillespie* and the *Coronado* cases. Chief Justice Hughes speaking for the Court, said: "We are convinced that the rulings in *Gillespie v.*

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[31] *People ex rel. Smyth v. Lynch et al.,* 254 N.Y. 427, 173 N.E. 571.
[32] 257 U.S. 501, 66 L. ed. 338.
[33] 283 U.S. 279, 75 L. ed. 1032.
[34] 285 U.S. 294, 76 L. ed. 813.

Oklahoma, and *Burnet v. Coronado Oil and Gas Company* are out of harmony with correct principles and accordingly they should be, and they now are, overruled.[34a]

Application of Doctrine

The discussion thus far has been limited to the nature of the immunity. It now becomes necessary to review the extent of its application. Does the immunity apply alike to Federal and state instrumentalities? If so, does it apply to all instrumentalities of each? What constitutes an instrumentality? These and other questions immediately arise, but limitations of time and space will permit only a brief outline of the area in which the immunity operates.

Professor Willoughby, in deploring the decision in *Collestor v. Day*,[35] criticizes the principle that the national government may not tax the instrumentalities of a state as unfortunate and constitutionally unnecessary. Professor Willoughby emphasizes that the state and the nation, in so far as their powers are concerned, are not upon an equal constitutional plane.

It is safe to say that Professor Willoughby's views have prevailed, at least until recently. The arguments advanced by those who maintain the position of Mr. Willoughby usually find expression in the thought that the powers of the Federal Government are limited, while those of the states are broad; that, therefore, it is not necessary to protect the states in all their endeavors, while it is necessary that all activities of the national government be cloaked with immunity to permit its proper functioning. The principle with respect to Federal instrumentalities is sometimes thus broadly stated. Assuming a status as an instrumen-

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[34a] Opinion not yet printed, but involved the Mountain Producers Corporation of Wyoming.

[35] Constitutional Law of the United States, Vol. I, 167.

tality of the Federal Government, then immunity necessarily follows. This view, however, seems subject to substantial question as a result of decisions in recent cases. In respect of the taxation of state instrumentalities, the rule has been clearly laid down that they are immune only when engaged in the performance of governmental as distinguished from proprietary functions. In *South Carolina v. United States*[36] agents of the state of South Carolina dispensing liquor were held subject to the payment of the Federal excise tax. In *Ohio v. Helvering*[37] the rule of non-immunity was extended to state-owned liquor stores. In speaking of the state, the Court said: "By its entering the market place seeking customers, the state divests itself of its quasi-sovereignty pro tanto, and takes on the character of a trader, so far, at least, as the taxing power of the Federal Government is concerned." Similarly, a state-owned railroad has been held subject to a penalty for the violation of the Carrier Act.[38] The same reasoning applies to agencies of municipalities, as, for example, a municipality engaged in the business of manufacturing and selling liquor.[39] That Chief Justice Marshall intended that the distinction between what we now know as governmental and proprietary functions should determine the existence or non-existence of immunity may be gathered from his language in the case of *Bank of United States v. Planter's Bank of Georgia:*[40] "It is, we think, a sound principle that when a government becomes a partner in any trading company it divests itself so far as concerns the transaction of that company of its sovereign character and takes that of a private citizen."

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[36] 199 U.S. 437, 50 L. ed. 261.
[37] 292 U.S. 360, 78 L. ed. 1307.
[38] *U.S. v. California,* 297 U.S. 175, 80 L. ed. 567.
[39] *Salt Lake City v. Hollister,* 118 U.S. 256.
[40] 22 U.S. (9 Wheat.) 904,907.

That such instrumentalities created under Act of Congress are not immune from state taxation is not to be doubted. For example, it has been held that a corporation organized under the laws of a state, all of whose stock was owned by the United States, such organization being for the purpose of providing wood to be used in the construction of airplanes, is not immune from local taxation.[41] Many railroads sought the cloak of immunity from state taxation on the theory that the substantial financial assistance lent them by the Federal Government and their performance of many functions for the Federal Government constituted them instrumentalities within the meaning of the doctrine of immunity. This, however, was denied.[42] As illustrative of the absurdity of overextending the doctrine of immunity, the case of *Susquehanna Power Company v. State Tax Commission of Maryland* is interesting. There a power company, in order to escape state taxation, advanced the ingenious argument that, since it was operating under a license issued by the Federal Power Commission, it was ipso facto a Federal instrumentality and immune. But Mr. Justice Stone, speaking for the Court, insisted the exemption rule

> must be given such a practical construction as will not unduly impair the taxing power of one government or the appropriate exercise of its function by the other.[43]

In a recent case not exactly in point with the discussion but interesting as indicating the trend of the Court, the Reconstruction Finance Corporation was held taxable upon its holdings of bank stock.[44] As we are well aware, however, Congress immediately amended the Act creating the Recon-

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[41] *Clallam County v. U.S.*, 263 U.S. 341, 68 L. ed. 328.
[42] *Thomson v. Union Pac. R.R. Co.*, 19 L. ed. 792; *Union Pac. R.R. Co. v. Peniston*, 21 L. ed. 787.
[43] 283 U.S. 291, 75 L. ed. 1042.
[44] *Baltimore v. State Tax Commission*, 298 U.S. 209, 80 L. ed. 586.

struction Finance Corporation so as to deny that it had intended to permit such local taxation.

It is to be noted that these cases just cited deal with attempts, some successful, some unsuccessful, at taxation of instrumentalities themselves. The rule may be summarized in no better language than that of Cooley when he says:

> Agencies of the Federal Government are exempt from state taxation only so far as such taxation may interfere with or impair their efficiency in performing the functions by which they serve the government. This has been stated over and over again. The state may tax the property of Federal agencies with other property in the state and as other property is taxed, when no law of Congress forbids, and when the effect of taxation will not be to defeat or hinder the operation of the national government. A different rule, as has been well said, "would remove from the reach of state taxation all the property of every agent of the Government." . . . The test is whether the tax deprives a person or corporation taxed, in truth, of power to serve the government as they were intended to serve it, or hinder the efficient exercise of their power.[45]

As respects the taxation of the employees of state instrumentalities, the Federal Government has always imposed the test of the nature of the function. The result at times has appeared inconsistent. For example, although the Chief Engineer for a municipally owned water works was exempt from taxation,[46] a member of the Board of Trustees of the Boston Elevated Railway Company, operated by the city of Boston, was subject to the Federal income tax.[47] A contrary holding occurred in the case of *Frey v. Woodworth,*[48] in which the wages of an employee of a municipally owned street-car system of Detroit was held exempt from the Federal income tax. The supervisor of a program of condemnation of land for streets in Chi-

[45] Cooley: *Taxation,* Vol. II, para. 607.
[46] *Brush v. Commissioner,* 300 U.S. 352, 81 L. ed. 691.
[47] *Helvering v. Powers,* 293 U.S. 214, 79 L. ed. 291.
[48] 2 F. (2d) 725, dismissed, 270 U.S. 669.

cago,[49] and the Director of the Port of Beaumont, Texas,[50] have been held subject to the Federal income tax. A contrary ruling was made in respect of the Chairman of the Port District Commission of New York.[51] The Board of Tax Appeals has held that the salary of a professor in the University of Maryland Law School for the year 1925 was not exempt,[52] while later it held that the salary of a part-time instructor in the same school for the year 1928 was exempt.[53] The salary of the pathologist-in-chief of the Boston City Hospital has been held exempt from Federal taxation,[54] as was also the salary of an employee of the California Golden Gate Bridge Highway District.[55]

The states recently have concertedly attempted to apply the same test in determining whether employees of instrumentalities of the Federal Government were subject to state income taxes.

It must be confessed that the law in respect of state taxation of the compensation of employees of instrumentalities of the Federal Government is as yet not clearly defined. Confusion arises as a result of the decision of the Supreme Court in the case of *People ex. rel. Rogers v. Graves,*[56] wherein the compensation of the General Counsel of the Panama Railroad was held exempt from the New York income tax. It must be noted, however, that in that case the Court inquired at length into the nature of the Panama Railroad and its connection with the Panama Canal. It concluded that this railroad and canal were established by

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[49] *Lyons v. Reincke,* 10 F. (2d) 3.
[50] *Wiggins v. Commissioner,* 27 BTA 526.
[51] *Commissioner v. Ten Eyck,* 29 BTA 1113, 76 F. (2d) 515.
[52] 20 BTA 949.
[53] 25 BTA 1385.
[54] *Mallory v. White,* 8 F. Supp. 989.
[55] *Commissioner v. Harlan,* 80 F. (2d) 660.
[56] 299 U.S. 401, 81 L. ed. 306.

Congress under its powers to provide for national defense and to regulate commerce.

There appears in that case nothing inconsistent with the view adopted by many states that an employee of a Federal instrumentality is exempt only when that instrumentality is engaged in the performance of a governmental function. There are, moreover, many state decisions and considerable dicta in Federal decisions indicating that the immunity of Federal instrumentalities extends only to the protection of governmental functions.

As indicative of this thought, the Supreme Court has held that the Federal Land Bank is not immune from attachment issuing out of a state court.[57] It has also held that an employee of the Emergency Fleet Corporation is not an agent of the Federal Government within the meaning of the criminal code.[58]

State decisions are much more decisive. For example, the salary of an employee of the Reconstruction Finance Corporation was held subject to the Montana income tax,[59] and the salary of the vice-president of the Federal Land Bank of New Orleans to the Mississippi income tax.[60] The Kansas Supreme Court has held that the compensation of a clerk and stenographer received jointly from the Federal Land Bank, the Federal Intermediate Credit Bank, the Production Credit Corporation and the Federal Bank for Cooperatives is subject to the Kansas income tax law,[61] and this despite the provision of the Kansas income tax law that:

> Gross income does not include the following items which shall be exempt from taxation under this Act. . . . Salaries, wages or compen-

[57] Fed. Land Bank, 295 U.S. 229, 79 L. ed. 408.

[58] *U.S. v. Strang,* 254 U.S. 491, 65 L. ed. 368.

[59] *Pomeroy v. State Board,* 99 Mont. 534, 45 P. (2d) 316.

[60] *Parker v. Miss. State Tax Comm.,* 174, So. 567, cert. den. 82 L. ed. (adv.) 105.

[61] *Clinton v. State Tax Commission,* 71 P. (2d) 857.

sation paid by the United States to its officials or employees including members of the Army, Navy and Marine Corps.[62]

The attorneys general of several states have passed upon the matter, in most instances holding compensation of employees of the alphabetical agencies subject to the payment of state income tax.[63] A regulation subjects the compensation of employees of certain New Deal agencies to the payment of the California income tax.[64]

On the other side of the picture we find the Board of Tax Appeals of Massachusetts holding that an employee of the Reconstruction Finance Corporation is exempt from the Massachusetts income tax on his compensation received therefrom.[65] A recent case has arisen in Kentucky involving the compensation of an employee of the Production Credit Corporation. The lower Court in an unwritten opinion held such compensation exempt from the Kentucky income tax.[66] An immediate appeal is being prosecuted to the Kentucky Court of Appeals.

That the Supreme Court in the *Dravo* case [67] recognized that the rule governing tax liability of independent contractors with the state was equally applicable to an independent contractor with the Federal Government may be noted from the following excerpt:

> The reasoning upon which that decision [*Metcalfe & Eddy v. Mitchell*, 269 U. S. 514] was based is controlling here. We recognize that in a broad sense the "burden of Federal taxation necessarily sets an economic limit to the practical operation of the taxing power of the states and vice versa." "Taxation by either the state or the Federal Government affects in some measure the cost of operation of the other." As "neither government may destroy the other or control in any substantial manner

[62] Kan. Gen. St. 1935, 79-3205.

[63] CCH Wis. CTS, para. 14-559; CCH Mont. CTS, para. 1517, Att'y Gen. of Mo. Opinion of May 5, 1937, cf. CCH. W.Va. CTS, para. 1512.

[64] CCH Cal. CTS, para. 19-053.

[65] *Sanders v. Commissioner*, CCH. Mass. CTS 85-281.02.

[66] *Kennesson v. Martin et al.*, Franklin Circuit Court, Dec. 17, 1937.

[67] Note 27, supra.

the exercise of its powers," we said that the limitation upon the taxing power of each, so far as it affects the other, "must receive a practical construction which permits both to function with a minimum of interference each with the other, and that limitation cannot be so varied or extended as seriously to impair either the taxing power of the government imposing the tax . . . or the appropriate exercise of a function of the government affected by it."

And later on the Court used this language:

While the Metcalfe case was one of a Federal tax, the reasoning and the practical criterion it adopts are clearly applicable to the case of a state tax upon earnings under a contract with the Federal Government.

Mr. Justice Stone pointed out in the case of *United States v. California* [68] that the doctrine of that case holding that a railroad owned solely by the state of California was nevertheless subject to a penal fine under the Federal Carrier Act might be equally applicable to the Federal and state governments.

Effects of Reciprocal Immunity

Let us now see how much property and income otherwise taxable is seeking immunity behind the skirt of this strange thing called "reciprocal immunity."

As of June 30, 1936, public securities which were wholly or partially exempt from taxation amounted to:

State	$20,000,000,000
Federal proper	33,000,000,000
Federal instrumentalities	11,000,000,000
Total	$64,000,000,000

Excluding from this group securities held by the United States or in sinking-funds, there are $17,000,000,000 of state securities and $37,000,000,000 of Federal securities.[69]

[68] Note 38, supra.

[69] Youngquist: "Elimination of Inter-governmental Exemptions Based on Federal and State Sovereignty," *Tax Magazine*, Nov., 1937.

The Federal income tax, if applied to interest on these now exempt securities, would bring in around $70,000,000 annually.[70] The revenue that would be produced if these securities were subject to ad valorem taxation can not be estimated in view of the great variation of rates imposed by several states.

In addition to this appalling sum of public securities, there are now more than three and one-half million public employees. Of this group, some 830,000 are in the service of the executive branch of the Federal Government alone. The total compensation received by public employees during the year 1935 was $5,617,000,000. The staff of the Joint Committee on Internal Revenue Taxation has estimated that the annual revenue to the Federal Government from securities now exempt and from state and local salaries would amount to more than $200,000,000.[71]

The evils of this immunity have been recognized by successive Presidents and Secretaries of the Treasury. Presidents Harding, Coolidge and Hoover and Secretaries of the Treasury Glass, Mellon and Morgenthau have proposed plans to remove the exemption of public securities. Resolutions have been adopted by such organizations as the National Tax Association, the Chamber of Commerce of the United States, the National Association of Real Estate Boards and the American Farm Bureau Federation condemning this reciprocal immunity.

The following joint resolution was introduced in the Senate of the United States, June 30, 1937, by Senator Byrd of Virginia:

Sec. 1. The United States shall have power to lay and collect taxes on securities, and the income derived therefrom, issued after the ratification of this article by or under the authority of any state but without

[70] Magill: "The Problem of Inter-Governmental Tax Exemption," *Tax Magazine*, Dec., 1937.
[71] Note 69, supra.

discrimination against such securities or income and in favor of securities, or the income derived therefrom, issued after the ratification of this article by or under the authority of the United States or any other state.

Sec. 2. The United States shall have power to lay and collect taxes on compensation paid, after the ratification of this article, by any state or any political subdivision thereof to its officers and employees but without discrimination against such officers or employees in favor of officers or employees of the United States or any other state.

A resolution introduced in the United States Senate, January 6, 1937, by Senator Lonergan, of Connecticut, would permit such taxation by the states as well as by the Federal Government.

The greatest ill resulting from this invidious doctrine lies, not in the loss of revenue to state and national governments, though that is considerable, but in its effect upon the morale of other taxpayers. It is indeed hard to answer the indignant query of the average citizen: "Why should I pay a tax on my income while you who make as much as I are exempt? And why should I pay a tax on the securities which I own, while you, owning securities far more valuable, are exempt?"

Perhaps Mr. Justice Clark was right when he said:

> The immunity of the sovereign from taxation would seem to belong to the legal philosophy of the Middle Ages and to be as unsuited to modern conditions as the immunity from suit.[72]

That the danger which Chief Justice Marshall feared in 1819 was not a matter of concern in 1927 finds apt expression in the classic words of Mr. Justice Holmes:

> The power to tax is not the power to destroy while this Court sits.[73]

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[72] *U.S. v. Hoboken*, 29 F. (2d) 932.

[73] *Panhandle Oil Co. v. Knox*, 277 U.S.218, 72 L. ed. 857 (dissenting opinion).

PART TWO

INTERSTATE TAX RELATIONS

CHAPTER V

INTERSTATE COOPERATION IN THE FIELD OF TAXATION

Tipton R. Snavely

Professor of Economics, University of Virginia

The topic for consideration this morning is one that has assumed especial significance in recent years. As long as the total tax burdens imposed upon the citizens of the respective states were comparatively moderate, it was possible for the states to pursue an independent course in respect to the various taxes which were interstate in character. The problems which arose were not compelling, because the injustices which resulted from overlapping taxation were not usually of such severity as to threaten the very existence of the source from which the tax was paid.

Unfortunately, perhaps this happy state of affairs can no longer be said to exist. While the tax burdens of the states alone have not increased sufficiently to jeopardize the existence of various business concerns and individual sources of taxation, the combined tax burdens of national, state, and local governments are not infrequently found to impose tax burdens beyond the extent intended by the respective tax powers. Furthermore, there appears to be little likelihood that the present totality of tax burdens will be substantially reduced in the years which lie immediately ahead. In an effort to prevent the injustices which have arisen from duplicate and overlapping taxes, students of taxation have devoted considerable thought to the discovery of

feasible means by which to bring about uniformity and reciprocity of action on the part of the various states. The leadership in the movement to achieve this goal has been taken primarily by state tax officials, and by tax associations and research organizations. Efforts at cooperation have been centered on the drafting of tax statutes and upon the interpretation and administration of the statutes which have come into existence.

The measure of success which has been achieved is of much importance, but it must be admitted that we are still far from the goal of cooperation that is devoutly to be wished and that would seem to be imperative if the states are to retain the taxing powers which they now hold as agencies of government.

It is not necessary to undertake in this introductory statement even to summarize the various kinds of taxes over which conflicts between the states have arisen, or the many instances in which double taxation exists, or in which undesirable competition between the states has developed, or the difficulties of administration which have complicated the entire situation. Such an enumeration would include taxes on alcoholic beverages, tobacco taxes, gasoline taxes, license taxes on motor vehicles, personal and corporate income taxes, estate taxes, capital stock taxes, taxes of various types on intangible personal property, sales taxes, an assortment of license taxes and a long list of miscellaneous taxes. The conflicts with reference to these taxes which have arisen between the states are much accentuated now as a result of the recent changes in the tax structure of the Federal Government.

In speaking of the problem of conflicting and overlapping taxation some two years ago, Secretary Morgenthau declared, "It has now become so acute in this country that it must be faced squarely." He continued: "Independent

levying of taxes by all of the various taxing authorities, without due consideration for the tax structure as a whole, results in unfair and uneconomic distribution of the burden, affecting the very foundations of government. . . . The greater problem is to restore equilibrium in the tax structure as a whole, in order primarily to be fair and just to every class of taxpayer." Can it be said that the states have made any real progress during the past two years toward the achievement in their own tax systems of that happy balance that Mr. Morgenthau has indicated as desirable for the tax structure as a whole? Or is it possible for the states to achieve the necessary measure of uniformity in taxation without the directing hand of the central government?

The extent to which the states, by their own initiative, can realize the objectives of greater uniformity and reciprocity in the whole tax structure is a problem of transcendent importance.

CHAPTER VI

GENERAL POSSIBILITIES OF INTERSTATE TAX COOPERATION

HAROLD C. OSTERTAG

Chairman, New York Joint Legislative Committee on Interstate Cooperation

THE recent and somewhat explosive movement for tax revision should not be confined to one or two levies aimed at the relief of corporations but should be extended on a broad front. The point is, let's take the corporate profits tax changes in stride as we revise our whole state and Federal tax structure, but, first and more important, let's attack the problem as a whole. There are other taxpayers besides the corporations who deserve a break at this time, and it is for these other taxpayers that I speak. The time for a complete overhauling of our state and Federal tax system is now. Business and industrial interests are awaiting it. The states are ready for it. And, for a change, Congress is presumably willing. The Administration *again* says that it will do something about it, and the taxpayer probably thinks from reading the headlines that Congress is undertaking general tax revision rather than limiting its efforts to altering the corporate profits tax.

The historical background of conflicting taxation as well as the problem itself will probably be painted by other speakers on this program; accordingly, I should like to devote some time to describing what has been done and what can be done to bring about real tax revision.

It has been estimated that twelve billion dollars are collected in taxes each year, of which five are collected by the Federal Government, two and one half by the states and the remainder by subdivisions of the states. That the state governments have a large stake in tax revision is thus apparent. That the state governments have also taken steps to solve this problem will be pointed out.

Interstate Commission on Conflicting Taxation

To begin with, it was a group of state officials who in 1933 first organized the Interstate Commission on Conflicting Taxation. This Commission, composed of 17 officials, was established in February, 1933, by the First Interstate Assembly, which was attended by 87 official delegates from 31 states. Senator Seabury C. Mastick of New York was chosen Chairman of the Commission. During the next two and one half years, research work of the Commission was carried on under Professor Clarence Heer of the University of North Carolina and later under Dr. James W. Martin of the University of Kentucky. The Commission reported to the Second Interstate Assembly in February, 1935, and at that time submitted its recommendations for both a short- and a long-range program. A further progress report on the work of the Commission was presented at the Third General Assembly which met in January this year.

Although the general recommendations of the Commission are familiar to all tax experts, I think it is important to review them briefly at this time: The Commission endeavored to segregate certain tax fields to state governments on the one hand and to the Federal Government on the other. First, the Federal Government was urged to relinquish the gasoline tax as a source of revenue. Second, the Commission recommended that Congress should also leave electrical energy taxes to the states for their exclusive

use. In both these fields the Federal Government was a trespasser on tax preserves originally left to the states. To balance this loss of revenue to the Federal Government, the Commission suggested that tobacco taxes and volume taxes on liquor be allotted to the Federal Government.

Although these general principles as set forth by the Commission were obviously ignored by Congress, nevertheless, it is believed that the Commission through its appearances at hearings before the Congressional Committees on Internal Revenue Taxation was instrumental in holding down rates, with the result that the competition for revenue between these two units of government was reduced. Other recommendations of the Commission which were also adopted by the Second General Assembly were:

> That the Second Interstate Assembly recommends Federal enactment of legislation allowing a credit against the Federal individual income tax for state individual income taxes and other state and local taxes of a personal nature paid or accrued;
>
> That a graduated plan be used to allow a substantial credit for lower incomes and a smaller credit for larger incomes, for example, about 75 per cent of the aggregate of the credits for taxes on incomes below $10,000 and 25 per cent of incomes above $10,000. The percentages selected should provide a total credit of approximately $150,000,000;
>
> That the additional Federal revenue to replace the Federal credit allowed to taxpayers for state taxes be secured by some one or more of the following means:
>
> a. Inclusion of dividend income in the Federal tax base as completely as other income;
>
> b. Amendment of Federal and state constitutions to permit the taxation of income from tax-exempt securities and of salaries of officials and employees of the Federal, state and local governments;
>
> c. Reduction of personal exemptions, including elimination of the earned income credit;
>
> d. Allowance of personal exemptions and credits for dependents in terms of tax.

Those who have given any thought to the solution of the problem of tax conflicts realize that the problem can be

solved only by a combination of the various plans. And in working out these lines of attack it is apparent that state officials must confer with Federal officials. The Tax Commission soon found out that although it was presumably officially established to represent the state governments in investigating this general field of conflicting taxation, there was a lack of any regularly established machinery through which they could confer with Federal officials. Thus, the Commission recommended to the Second General Assembly the establishment of a Tax Revision Council which, through its membership, would provide the means for official conference and continuous contact between state and Federal policy-forming officials for the joint solution of these difficulties.

Tax Revision Council

The Second General Assembly of the Council of State Governments, which was attended by 153 official delegates from 41 states, approved these recommendations with the result that the Tax Revision Council was established, composed of 24 officials—8 official representatives of the Federal Government, 8 of the state governments, and 8 of the local units of government on its membership. The General Assembly directed the Tax Revision Council "first, to study the problem of multiple taxation by competing units of government; and, second, to determine the functions which can be performed best by the Federal Government and those which more properly fall to the states and their subdivisions."

Hon. Henry Morgenthau, Secretary of the Treasury, was chosen as its first Chairman, later to be succeeded by Hon. Robert L. Doughton, Chairman of the House Ways and Means Committee. Other prominent Federal officials serving include: Senators Pat Harrison and William H. King;

Congressman Fred M. Vinson; Lovell H. Parker, Chief of Staff Joint Committee on Internal Revenue; and Doctors Roswell P. Magill, George C. Haas and Herman Oliphant of the Treasury Department.

Among the prominent state officials are: Mark Graves, President of the New York State Tax Commission; Senator Seabury C. Mastick of New York; Assemblyman Laurens M. Hamilton of New York; Henry F. Long, Commissioner of Corporations and Taxation of Massachusetts; C. H. Morrissett, State Tax Commissioner of Virginia; Senator George Woodward of Pennsylvania; and Hon. William B. Belknap of Kentucky. The states through their Interstate Assembly authorized the appointment of those officials representing state legislative and administrative viewpoints.

In making the appointment of representatives of local governments, the American Municipal Association, the United States Conference of Mayors, and the Municipal Finance Officers' Association each selected one person representative of city viewpoints and public finance. The Chairman was asked to appoint three representatives of county, rural school district and other local viewpoints. Local representatives on the Tax Revision Council include: Kenneth J. McCarren, President, Board of Assessors of Detroit; Charles J. Fox, City Auditor of Boston; Mayor Daniel W. Hoan of Milwaukee; and C. A. Dykstra, former City Manager of Cincinnati.

The Progress Report of the Commission on Conflicting Taxation in citing the need for a Tax Revision Council states:

> Tax conflicts arise largely from the fact that the Federal Government and the states have constitutionally coordinated taxing jurisdiction in all important fields except property taxation and custom duties. . . .
>
> Therefore, no matter what legislative changes may be adopted to reduce the evils of conflicting taxation, it will be essential to maintain

machinery for dealing continuously with the problems of this sort which evolve from the operation of our plan of government.

It has become commonplace among students of government that agreement on controversial public questions is reached almost invariably, if at all, through personal conference. This is particularly true in the field of taxation, especially in the matter of developing a spirit of interstate and Federal-state comity; for in this field an attitude of give-and-take must characterize any successful procedure. . . .

What work has been done in the last eighteen months on the problem of conflicting or multiple taxation has been undertaken by the research organization of certain state tax commissions, and the research organization of the Congress and the Treasury. These, however, have not been coordinated. It is necessary, for the accomplishment of the plans of both of these commissions, that funds be provided for such study and coordination, and that it be done in such a way that the work of the commission receives official consideration when presented both to Congress and to this Assembly. . . .

The Federal Government has not yet participated financially in carrying forward this work. Funds of the Council of State Governments to the amount of $25,000 have been assigned to the tax investigation and revision work, but no great amount of progress has been made in the work, since the states have taken the position that the effectiveness of the Tax Revision Council lies in the whole-hearted support and participation of those governments which it represents. Accordingly, until the Federal Government shall bear its share of carrying forward this work, the Tax Revision Council will remain relatively inactive. The Interstate Commission on Conflicting Taxation will continue to function, as do the other interstate commissions established by the states through the Council of State Governments.

The growth of the Council of State Governments has paralleled the development of the Interstate Commission on Conflicting Taxation and the Tax Revision Council. It has been organized by official legislative action of 35 state governments. It is primarily concerned with those governmental problems over which the Federal Government has no jurisdiction. Working through 35 affiliated commissions on interstate cooperation, the Council of State Governments seeks to develop better coordination and more active cooperation among the states. As many of you know, it serves as the official research agency and clearing house for

the American Legislators' Association, the National Association of Secretaries of States, the National Association of Attorneys General and the Governors Conference. The various General Assemblies which have been mentioned at some length are the biennial meetings of the 35 commissions which are affiliated with the Council of State Governments. These cooperation commissions, or joint committees, are generally composed of 15 members equally representative of the Senate, the Assembly, and the administrative departments of the state governments.

Practically all the state representatives of the Tax Revision Council are members of their respective state cooperation commissions. This is as it should be, because taxation is one of the principal fields for investigation listed in the statutes or resolutions establishing the commissions. The deliberations of the Interstate Commission on Conflicting Taxation are followed with much interest not only on the floor of the General Assembly when it meets, but in the legislative halls at home. The official journal of the three Assemblies indicates how carefully reports of the Interstate Commission on Conflicting Taxation are studied and debated by delegates from practically all the states. Only two states failed to send delegates to the Third General Assembly held in Washington last January.

Lack of Federal Cooperation

As Chairman of the New York Joint Legislative Committee on Interstate Cooperation, I can assure you that our Committee is interested in seeing that the Tax Revision Council is given support. Personally, I cannot understand the indifference of the Federal Administration to this important work. One would think that they would welcome the interest of the states in reaching a definite solution of this problem. It is strange, but true, that here is a field

in which nothing has been done because of the indifference of the Federal Government. Those in Washington have never hesitated to point out the indifference or the inability of the states to handle so-called national problems. But here is a problem which is interstate, national and international in its ramifications, and yet we find the Administration stalling for time, holding in the clinches, and even refusing to pay a small deposit as a token indicating its willingness to participate in this mutual undertaking. It is difficult to understand because as President-elect, in 1933, Mr. Roosevelt said in a message to the First Interstate Assembly:

> Many exceedingly important public questions are pressing for solution, and among the more urgent of these is the very one with which your Association proposes to deal.
>
> In the past, the Federal Government has passed revenue legislation with too little consideration for state taxing systems and, on the other hand, the states have legislated with little reference to the Federal revenue plan and with almost no consideration for the tax programs of other states. This is not as it should be. I have given considerable thought to this problem and it is my hope to make at least a small contribution to a better synchronized Federal, state and local taxing system.

And again as President, in his message to the Second Interstate Assembly, he re-affirmed his interest in working out this problem whose solution requires coordinated effort on the part of state and Federal governments.

The Secretary of the Treasury has also time and time again emphasized the need for coordination in this field.

So much for what might be called the Administration's attitude towards this problem. Now for the states:

Governor Lehman's statesmanlike address before the Governors Conference in Atlantic City, September 14, 1937, sounded the keynote for the states when he said:

Nevertheless, as things now stand, every American state, I suspect, is finding it difficult to finance its operations and the expenses of its localities without resorting to the enactment of tax laws inimical to the economic interests of the state. And that is probably due to the fact that the national government is almost monopolizing so many of the important tax fields.

If I see the situation clearly, we should without further delay—and when I say "we" I mean the states and the national government—inaugurate plans for coordinating Federal, state and local revenue systems. We owe that duty to the taxpayers. We can improve the present situation only through effective and close cooperation between the Federal and state governments and between the several states themselves. Without such cooperation each political unit will continue to go its own way and we will have accomplished nothing.

Again, Mark Graves, President of the New York State Tax Commission and member of our Cooperation Committee, states the case from the standpoint of the state tax administrator when he says:

The Federal Government, like the biggest child in a family, seizes the largest, reddest, juiciest apples in the tax dish, monopolizes all of the important tax fields and leaves to the states and their localities the cull apples. States, on the other hand, enact tax laws without considering the impact of Federal taxes, taxes of other states or the effect of their laws on the welfare and prosperity of the country, as a whole. The result of all this scrambling is that the states are literally forced to tax real estate almost to the point of confiscation, and levy other taxes not suited to state and local use, or at such high rates as to be harmful to the interests of the state. No subject in the field of taxation is more important or in greater need of solution. Several forces have been working on the problem, and now, with the support of the Governors' Conference, it is hoped that something definite may be accomplished.

Furthermore, as Chairman of the New York Cooperation Committee and a member of the Assembly, I have frequently said at interstate conferences that the New York Cooperation Committee was interested in simplified Federal, state and local tax systems. Our New York Committee, I have indicated, is anxious to join with other states in unraveling this tangled skein of taxation and indeed we are

prepared to take the leadership, if need be, *in doing something* rather than talking about what ought to be done. It is encouraging to note that, as a result of our stimulation, and with the assistance of Henry Toll of the Council of State Governments, other cooperation commissions have been encouraged to join with us in bringing our problems to the attention of Congress and the President. Here is what some of the cooperation commissions have done or are preparing to do.

First, they have endeavored to apply pressure on their state congressional delegations in the usual way, such as writing letters to members of Congress as individuals, or directing the chairman of the cooperation commission, or the governor of the state, to point out the need for tax revision on a national scale. Second, they are endeavoring to interest congressmen in this problem by holding what I have described as Congressional tax dinners for state and Federal office-holders at which the governor, the chairman of the cooperation commission, and the leading state tax officials would point out in carefully prepared addresses the immediate need for a joint state and Federal attack on conflicting taxation and the adoption of a unified program of action aimed at tax revision. Certainly, these dinners would demonstrate that the states, through official agencies such as their Interstate Commission on Conflicting Taxation and the Tax Revision Council, were ready to undertake immediate tax revision negotiations, and that their efforts in the past had been blocked by the refusal of the Federal administrators to sit at the same conference table with the state representatives for the purpose of bringing about a solution to this problem in the manner which I have indicated.

Let me emphasize, and re-emphasize, that this is the way to solve the problem. There is no need to delay bringing

about a solution by resorting to the appointment of Federal or state commissions to study or re-survey the field. We have had enough of this type of commission. I am not criticizing the general necessity for study commissions of this type, but I do say that we have reached the stage where a semi-permanent "action" commission such as the Tax Revision Council is our only hope. This Council, if activated by Federal agencies, including Congress, is prepared to carry on the fact-finding and general survey work of the so-called study commission, but, in addition, it is qualified to serve as a semi-permanent agency whose purpose it would be to carry on the planning and actual negotiation needed to bring about a real, practical and continuing tax revision.

Interstate Cooperation

Until this is done, and I think we are agreed that it should be done, the states through their cooperation commissions and such agencies as the Federation of Tax Administrators should not lose sight of the fact that some progress can still be made in this direction by the use of those types of interstate cooperation set forth in the report of our Subcommittee on Taxation as published in the annual legislative report of the Joint Committee on Interstate Cooperation. This report, which was written with the assistance of Mark Graves, President of the New York State Tax Commission, pointed out that interstate tax cooperation was possible, first, through the medium of reciprocal tax laws, the aim of which is to promote uniform and non-discriminatory taxation, as, for instance, the extension of reciprocal insurance taxes, reciprocity of personal income taxes, and of course the continuation of reciprocal inheritance taxation. A similar example is the use of reciprocal agreements between state tax officials for inspection of income tax returns.

Second, through cooperation in administrative procedure, by the adoption of reciprocal administrative and legislative regulations promulgated by the officer charged with the administration of tax laws. The use of a uniform form by motor fuel distributors in ten or more of our eastern states and a free exchange of information about the shipment of motor fuel in interstate commerce by these administrators is a case in point. The same type of information is exchanged concerning shipment of alcoholic beverages, although the use of this method is not as general as in the case of the motor fuel tax. The establishment of 35 cooperation commissions and their desire to promote uniform and reciprocal legislation which is in the public interest, will probably prevent or reduce the present number of restrictive provisions which prohibit administrative officials from disclosing or exchanging information with like officials of other states.

Third, though the use of interstate compacts in the tax field has been mentioned by tax authorities as a possible way out of the morass, our Subcommittee urges caution in these words:

> Your Subcommittee is unable to see at this writing just how or where interstate compacts may be invoked in the tax field. In that regard the problem is somewhat different from, for instance, the administration of criminal laws or other statutes not involving the economic life of a state. Moreover, political philosophies vary widely in American states, even though their economic interests may be very much the same. One has but to study the tax systems of Massachusetts, Connecticut, New York, New Jersey and Rhode Island to see the divergent views which obtain.
>
> Obviously, under such conditions the legislature of a given state will be reluctant to enter into a contract with the legislature of another state that it will or will not adopt a certain form of taxation or to fix a minimum or maximum rate of tax. In fact, even though the political philosophies of the legislatures of two states might be in accord in the given year, it may seriously be questioned whether they would with propriety enter into contracts binding upon future legislatures.

The Subcommittee, however, does point out that compact or treaty relationships between the states and the Federal Government may be worth considering, especially for those fields which are used by both the Federal Government and the states. Our report continues:

Your Subcommittee sees as a possibility the creation of compact or treaty relationships between individual states and the Federal Government, having for their purpose the elimination in some instances of duplicate state and Federal levies, and in other instances that one of the governments may contract with the other to raise, in addition to its own tax, a tax for the use of the other contracting party. The value of such a program, if found feasible, would be first to establish a segregation of source of revenue in so far as it is found practicable; second, to reduce administrative costs, and third, to relieve the taxpayers of a heavy burden of annoyance, irritation and actual cost of tax compliance.

Conclusion

There is no doubt that some of the obstructions to a simplification of our tax system can be surmounted by administrative agreements or interstate or state and Federal compacts, but during the past five years the states in their quest for additional revenue have nearly *doubled* double taxation. The score to date:

Tax	Number of States levying tax 1933	1937
Tobacco	13	21
Personal income	21	31
Corporation income	23	37
Alcoholic beverages	0	48
Sales	8	28

The Federal Government and a number of municipalities have continued or recently begun to levy taxes in these fields either by right of prior occupation or because of need for additional revenue. Now is the time to call a halt. We should start the boulder rolling the other way. The states

are pushing together and will continue to do their share, through their Commissions on Interstate Cooperation. We thing it is time for the Federal Administration to join forces with the states in attacking this problem.

CHAPTER VII

EXAMPLES OF INTERSTATE ADMINISTRATIVE COOPERATION IN THE TAX FIELD

ALBERT LEPAWSKY

Executive Director, Federation of Tax Administrators

A CURRENT story in Chicago police circles relates the case of a fugitive from justice, who was arrested by Chicago police in Gary, Ind., and hustled across the state line to Chicago police headquarters without benefit of counsel, and was later executed without benefit of clergy. There was involved no question of rendition through the governors of the respective states, nor any question of invoking a reciprocal statute concerning fugitives from justice, because at the time there was no such statute. From the standpoint of the police officers, there apparently did not have to be, for they operated on the maxim that once you get a prisoner into your own jurisdiction he's yours, regardless of the method used.

The moral of this story is that, while interstate legislation as analyzed in previous discussions at this meeting is a great aid to interstate cooperation, and in fact is one of the principal and soundest legal bases for such cooperation, interstate legislation must as a matter of practice be supplemented by effective administrative cooperation.

The American governmental scene is shot through with a series of such administrative practices of an interstate character, which are as often as not devoid of any specific statutory basis and frequently are extra-legal in character.

Just how widespread is interstate administrative cooperation, whether within or without the law, no one really knows, for it is a field which has been relatively untouched by researchers, who place the emphasis too often on what the statute books say or should say rather than upon the actual administrative practices. But it is a safe guess that administrative collaboration of this kind is more widespread than the experts in government now suspect.

I have been asked to bring forth examples of administrative cooperation from the tax field, and I should like to present to this group some information about the taxation of gasoline and tobacco where the movement of the taxable product is easily accomplished and thus makes the problem particularly susceptible to interstate complications.

Cooperation in Gasoline Tax Administration

In the gasoline or motor fuel tax field, several states had been faced almost from the beginning by a system of organized tax evasion on the part of a small number of less reliable gasoline dealers. This was found to be the case especially on the waterways networking the densely populated areas of New Jersey, New York, and New England. In New Jersey, for example, a few careful investigations disclosed that, while certain petroleum companies had reported, on the forms provided by the Motor Fuels Division of the state, that their cargoes were to be exported to another state and were therefore exempt from the New Jersey gasoline tax, actually the boats and tankers never left the state but were unloaded at another port in New Jersey, and the cargoes sold untaxed.

This kind of bootlegging could be combated by at least two complementary methods: first, a river patrol system could be set up; and, second, a system of interstate report-

ing and clearance of information could be established. New Jersey has used both methods with excellent results.

The second method, involving interstate reporting, constitutes a type of administrative cooperation that is not merely casual or occasional. It is a regular practice implemented by a system of exchanging uniform reports in all the 13 states in the Northeastern Region. After much conference and consultation, a uniform report form was worked out with the cooperation of the gasoline distributors of the Northeastern States Gasoline Tax Conference. At the present time, the administrator in one state can talk the same shorthand language as the administrators in the other states when exchanging information, and can obtain almost automatic administrative clearance. The oil dealers also prefer the system because it eliminates duplication of their own reporting duties, since they operate in several states at once and under the plan of uniform reporting are not burdened by dissimilar reports.

The system works as an automatic check upon the interstate movement of gasoline in the following manner: Company A of New Jersey reports on the uniform report blank that it is selling gasoline to Company B in New York State, but Company A is nevertheless charged with the tax by New Jersey and will receive no credit or deduction or refund from New Jersey for the export unless the following steps are taken:

1. Company A fills out the New Jersey export form in duplicate and sends it to the New Jersey Motor Fuels Division the day on which the sale is made.
2. New Jersey sends one copy of this export report to New York's Motor Fuel Tax Bureau.
3. The Company fills out the New York import form in duplicate and sends it to New York's Motor Fuel Tax Bureau within 24 hours.
4. New York sends a copy of the import form to New Jersey.

5. New Jersey and New York compare their copies of both the import and export returns and find that they match.
6. New York reports to New Jersey that the cargo, as described in the report, has entered the state.

The advantage of this system of uniform reporting and interstate administrative cooperation lies in the fact that, unless the dealer wants to engage in outright blockade running (for a New Jersey boat is constantly patrolling the river and inspecting the cargo), he not only has to pay the tax but is charged with the tax before the oil begins to move in interstate commerce. Moreover, the gasoline dealers, with few exceptions, have cooperated fully in helping to develop and in finally complying with the reporting system.

There are no interstate compacts, no reciprocal statutes, and no specific provisions have been discovered in any law of the states permitting this kind of interstate cooperation. In New Jersey, for example, which was one of the leaders in the Northeastern States Gasoline Tax Conference, the closest we come to a statutory basis for the export and import reports is the provision that relief from the tax for exported fuel will be allowed only when evidence of the export satisfactory to the state tax commissioner has been submitted. The state tax commissioner, through the regulations of the Motor Fuels Division, informs dealers that the only sufficient evidence which will be accepted is the export and import report required by the Division. In the words of the New Jersey administrator:

> What we have done in this regional conference has confirmed me in my belief in the power of the informal conference to set down and bring into existence those safeguards that perhaps a statute could not accomplish.

The Federal Government has also done its share to facilitate these interstate administrative relations in the gasoline

tax field. In the beginning, not all the Northeastern States were equally enthusiastic about this form of administrative cooperation. Consequently, the good offices of the Federal Government were sought and, after further consultation, arrangements have been worked out whereby the administrators in the Northeastern States receive not only their own reciprocal reports, but also reports from the Department of the Interior, known as OCR reports, which show the detail of every movement of motor fuels or oil carried from the producing state by ship to any other state.

Export and import report, exchange of state uniform reports, Federal OCR reports, do not in themselves solve the interstate problem, but when taken together with certain state common carrier reports, miscellaneous data collected by field investigators, and statistics obtained from one company affecting in any way the movement of gasoline to or from another company, the data are all correlated and charges are made on the books of the gasoline tax offices of the various states against the proper company, with corrections, refunds or other claims left for consideration at the time of the periodical audit.

Cooperation in Tobacco Tax Administration

In the field of tobacco taxation, the interstate problem also seems to be of importance because organized interstate evasion is apparently threatening this tax as one of the major sources of revenue in some of the 21 states having tobacco tax laws. This problem was the center of discussion at the recent meeting of the National Tobacco Tax Conference at Birmingham on November 15 and 16.

Interstate tobacco tax evasion is systematic, and difficult to cope with. Fly-by-night firms are frequently set up just across the state boundary, and these firms advertise, solicit, ship and mail under the guise of interstate commerce,

thus keeping themselves immune from the tobacco tax. Texas, for example, estimates its annual loss in uncollected cigarette taxes resulting from parcel post shipments to be anywhere from $500,000 to $750,000, out of a total tax collection of some six and one-half million dollars.

Such practices are by no means universal. Many firms desiring to comply with the tobacco tax laws in states where their sales are heavy, actually purchase the tobacco tax stamps of the receiving state and affix them before shipment. This sort of interstate compliance is the practice with some dealers in Florida, which has no tobacco tax, when these dealers ship to Alabama, which has a tobacco tax. Tennessee reports that dealers shipping from out of the state have agreed that they will not ship cigarettes to Tennessee by parcel post, in return for Tennessee's exemption from its elaborate tobacco tax import reporting requirement.

To catch the tobacco tax evader, several states in the South have established cooperative practices of various kinds. In June, 1937, representatives of the tobacco tax divisions of Arkansas, Mississippi, and Tennessee met and agreed to furnish information to each other on all shipments and sales to consumers made from one of these states to any other. Shortly thereafter, Oklahoma, Texas, Louisiana and Alabama conferred, and this cooperative arrangement was extended to cover all seven states of the lower Mississippi region. Moreover, Arkansas assigns upon request from another state an auditor from its tobacco tax division to accompany any out-of-state official auditor who comes to Arkansas to make an audit of firms in connection with the enforcement of the tobacco tax laws of that state.

The interstate picture is not altogether a peaceful one, of course. There is administrative conflict, as well as administrative collaboration among the states. In the

gasoline tax field, for example, one of the current problems is the taxation of gasoline carried by long-distance truck or bus in auxiliary tanks into other states, without being subject to the tax in those states. Legislation in 18 states attempts to tax gasoline which exceeds a certain gallonage limit or exceeds the capacity of the fuel tank of the particular vehicle. But there are still cases where, as in one state, a truck company has so much long-distance interstate business that it has established itself as a wholesale distributor, pays the tax in the home state, loads up with a few hundred gallons of gasoline for a 2,000-mile round trip, and, with all the wear and tear upon the roads of other states through which it passes, buys no gasoline and avoids the motor fuel tax outside its home state.

Nor is the system of Federal-state relationships smoothly worked out in all cases. Today a major source of difficulty for both gasoline and tobacco tax administrators is the question of applying taxes to the sales made on Federal reservations and post exchanges. The Hayden-Cartwright Act was passed by Congress to clarify the problem in the gasoline tax field, but state administrators still complain that there is no certainty, uniformity, or adequate control on this question. A pending bill in Congress, known as the Tarver Bill (H.R. 8045), now seeks to solve the parcel post shipment problem which is bothering the tobacco tax administrators of the country, by permitting postmasters to furnish state officials with the names and addresses appearing upon parcels containing merchandise subject to state taxation.

A thorough study of the whole problem of administrative cooperation and conflict is sorely needed at the present time, for it involves not merely the question of leakage in the enforcement of state tax laws, but touches upon the entire system of interstate relationships and of potential

interferences with the flow of interstate commerce which, as I read the pages of history, was one of the major causes for the substitution of our present Constitution for the Articles of Confederation.

CHAPTER VIII

INTERSTATE RECIPROCITY IN CONNECTION WITH CORPORATE AND PERSONAL INCOME TAXATION

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Interstate reciprocity in general terms and in a broad sense is by no means a modern concept. Certain acts of reciprocity as between the states are obligatory. The Federal Constitution requires that the states shall deliver to each other fugitives from justice; that the records of one state, properly authenticated, shall have full credit in the other states; that the citizens of one state shall be citizens of any state into which they may remove; and that the privileges and immunities of a state cannot be abridged by the laws of another state. Other acts of reciprocity are purely voluntary.

Interstate reciprocity in connection with corporate and personal income taxes is assumed to relate to that action as between states in connection with the types of taxes referred to whereby state A, for instance, confers some benefit upon state B or its citizens, corporations or interests because of, or in expectation of, similar action upon the part of state B with respect to state A. It is distinguishable from so-called retaliatory measures in that its method of approach is diametrically opposite. Retaliatory measures threaten harm to another state if it does not do thus and so. Reciprocal measures offer benefits.

Probably the best illustration of retaliatory legislation in the field of taxation is that having to do with insurance companies. The principle which has long seemed to obtain there is "An eye for an eye and a tooth for a tooth." Connecticut is the only state which, at least in recent years, has had purely reciprocal provisions; that is, it taxes the insurance companies of other states doing business therein in exactly the same manner and by the identical rate in use by the foreign state in taxing Connecticut insurance companies. The majority of other states have an established premium rate, and charge more only if a foreign state charges their companies a higher rate. Generally speaking, retaliatory insurance tax laws have not been enforced with great strictness, although the tendency now would seem to be toward more rigid retaliation with the purpose of obtaining better conditions for home companies.

An example of such effect appears in the reduction in the premium tax rate of the state of Ohio. The rate of 2½ per cent prevailed in that state for about 39 years, but in 1927 the Legislature raised it to 3 per cent. Litigation arose on the question of the retroactive feature of the bill, but in 1929 a return was made to the old 2½ per cent tax as a result undoubtedly of the hardship worked upon many Ohio companies when doing business in other states. The tendency is, of course, to effect a uniform rate, although high rates prevail in many southern states which have difficulty in raising revenue. In some of these states the companies of other states have been actually known to pay a tax greater in amount than the amount of premiums received. Such states, however, usually have but few, if any, domestic companies doing business in other states which by retaliation might bring about a lower rate. By and large, it is probably true that there is a nearer approach to uniformity in the taxation of insurance companies than in the taxa-

tion of other classes of taxpayers. It would appear to be a proper deduction that this result has been largely influenced, if not directly brought about, by retaliatory provisions.

On the other hand, the extensive employment of reciprocal provisions was well illustrated some years ago in connection with inheritance taxation. Before certain comparatively recent decisions of the United States Supreme Court, such as *Farmers Loan and Trust Co. v. Minnesota* [1] and *First National Bank of Boston v. Maine* [2] disposed of the problem, legislative reciprocal provisions to avoid multiple taxation of the passing of intangible property reached very considerable proportions. In 1930 all but eleven states had provided for such reciprocity in one form or another.

Reciprocity in Corporate Tax Administration

The appearance of reciprocal provisions in connection with personal and corporate income taxes in express terms of the enactment has not been as extensive, although such measures have been employed to some degree in one form or another. The Massachusetts personal income tax law, for example, exempts from taxation the interest upon deposits in savings banks in other states which exempt from taxation the interest on deposits in Massachusetts savings banks.

It is not necessary, however, that reciprocal action shall take the form of legislation whereby benefits to another state are conditionally extended in express terms. The desired results may be achieved through administrative action which finds expression in cooperative effort toward a definite end. The authorities charged with the administration of tax laws in two or more different states may

[1] 280 U.S. 204.
[2] 284 U.S. 312.

unite in an effort to advocate and work for tax laws in each which will be fair to the interests of the other state. Or the state may hold out the olive branch of its own volition with the thought that if it sets the example of fairness other states will fall in line. This motive no doubt was one of the factors underlying the action of Massachusetts in 1919 when it provided for the taxation of foreign and domestic corporations upon substantial parity.

Prior to that date foreign corporations had been taxable locally upon all their tangible property in the commonwealth as well as subject to an excise based upon capital stock, whereas domestic corporations, though paying a greater excise, were exempt from local taxation upon all tangible property except real estate and machinery. The net result undoubtedly favored domestic corporations. Under the present law domestic and foreign corporations carrying on business in Massachusetts are on very nearly an even footing, such differences as there are being principally attributable to constitutional limitations. Under temporary provisions of law which have been in effect since 1933, this parity extends even to the taxation of dividends paid by such corporations when received by individual inhabitants of the commonwealth.

A factor to be borne in mind in considering the need or desirability of reciprocal action, or action which is calculated to conduce toward other states acting in a friendly manner in the same field of taxation, is the character of the tax. Many so-called corporation income taxes are in fact excises measured in whole or in part by income. In such cases the opportunity for overlapping, and hence the basis for reciprocal action, is broader than in the case of property taxes. For instance, Massachusetts can measure an excise for its own corporations by the value of capital stock, and grant no deduction for tangible property in another

state or country, even though it would lack jurisdiction to impose a tax on property so situated. This is, in fact, what it did do in the early days, the deduction for such property being provided only after the lapse of many years. The overlapping may similarly arise with respect to intangibles. The deduction for cash and accounts receivable attributable to an office outside Massachusetts did not become permanently a part of the law until 1919. So, too, in the case of an excise measured by income, income from sources such as interest from Federal obligations may be included in the measure of the excise, even though a state could not constitutionally subject the income to a direct tax. Hence, in this type of taxation there is more latitude for one state to enact legislation which may be harmful to the interests of another state, and the occasion and opportunity is greater for reciprocal action, or action that at least is not inimical to another state.

In connection with the problem of allocation of income whether under a direct tax or employed as the measure of an excise, there is need for cooperative effort as between the states. Today there is great diversity in the factors employed in different states to determine the income earned or taxable therein. At least one state has provided no method of allocation, but the common practice is to employ one or more allocating factors. Among the factors adopted are tangible property, gross receipts or sales, payroll, manufacturing costs, accounts receivable, shares of stock of other corporations owned, purchases, cost value of capital assets, and net cost of sales. Some states rely upon a single factor, but the majority have adopted either two or three factors. A few laws permit the suggestion of an alternative fraction, and most of the statutes permit separate accounting.

The most commonly employed factors are tangible property, payroll and gross receipts. These fractions were

adopted by Massachusetts as early as 1919, have by and large given pretty general satisfaction as applied to manufacturing and mercantile corporations, and since then have been fairly closely followed by several other states. The committee of the National Tax Association that was appointed some years ago to study and report upon the problem of allocation soon discovered some of the difficulties inherent in the solution. States in which purchasing activities are large desire a purchasing factor; those where sales activities predominate desire much weight given to the sales factor; and those in which manufacturing is the chief industry naturally seek to strengthen the effect of tangible property and wage factors. The very fact that there still exists a great lack of uniformity in the methods actually in operation, is evidence of the obstacles in the way of submerging these divergent points of view. Although the Hans Reese case stands as a barrier against ruthless, arbitrary or capricious methods productive of grossly distorted results, it is no guarantee that rules conceived in fairness, if varying from state to state, will not in their application result in the taxation of more than 100 per cent of the income; that is, some of the income will be twice taxed or twice used as a measure of taxation. The adoption of uniform methods of allocation can alone insure the taxation of exactly 100 per cent—no more and no less.

Reciprocity in Personal Income Tax Administration

In the field of personal income taxes, again there is possibility of overlapping as between states. One state may proceed upon the theory that domicile affords a fair basis for taxing a person upon his entire net income, including that which flows from business activities. It is argued that he enjoys all the benefits and advantages that flow from living in the state, and that net income is a reasonable

measure of his ability to pay for these advantages which are supplied at the expense of the state. On the other hand, however, some other state may say with respect to the same income or that portion derived from business activities: "Although it is true that the person who earned this income lives in another state, his place of business is in this state, and it is this state that threw around him the blanket of protection and accorded him the advantages of streets, lighting, etc., that enabled him to prosecute his business activities successfully and derive profit therefrom. Therefore this state is entitled to levy a tax upon so much of the net income as is earned within its confines."

Probably the average taxpayer has not read or does not recall the admirable report made in 1919 entitled "Preliminary Report of the Committee Appointed by the National Tax Association to Prepare a Plan of a Model System of State and Local Taxation." Accordingly, he may not appreciate the theoretical justification for both impositions and, having included the income in his Federal return, he may have a feeling that when two other jurisdictions tax that same income, as a practical matter government is cracking down rather hard with respect to the same source of revenue. Certainly it is an area where the states may well act with some degree of restraint.

Another twilight zone in personal income taxation, which judicial interpretations have not as yet disposed of with sufficient precision to establish the bright line, relates to income flowing from property held in trust. Should the state where the trustee resides tax the income on the ground that the situs of the intangible follows the legal title, or should the state where the beneficiary resides tax such income? The case of *Maguire v. Trefry*[3] at the time of its decision seemed to indicate that judicial sanction would

[3] 253 U.S. 12.

be given to a levy which followed the beneficial interest, but more recent decisions of the United States Supreme Court indicate that the import of this case is to be limited. However this may be, it seems manifestly unjust that both the state where the trustee resides and the state where the benficiary resides should tax the same income. Here again there is opportunity for restraint and cooperative action upon the part of the states.

Another instance arises in the case of estates of deceased persons. Should the state where the decedent last dwelt lay the tax, or the state where the beneficial interest lies? Again, in the case of income accumulated for the benefit of unknown or unascertained persons, there may be difference of opinion as to what state is most entitled to lay the tax.

The foregoing are simply illustrative of the possible injustices which may be done the taxpayer if each state attempts to grab the utmost it can without regard to the interests of other states or to the unfairness to those who have to bear the tax burden. In the last analysis it would seem that equitable distribution of the tax burden should be the paramount consideration in taxing enactments and administrative policy affecting persons and corporate bodies whose interests extend beyond the boundaries of the taxing state into other states, as well as in dealing with tax problems not involving extraterritorial interests. In the solution of the problem of allocation, perhaps the voluntary adoption of uniform methods conceived in an effort to be as fair as possible to the interests of all, will accomplish more than an effort to compel by threat through retaliatory provisions or promise of reward through reciprocal measures. The end sought is of more importance than the method employed to achieve that end. If that purpose

can be accomplished through pursuing a cooperative policy without resort to reciprocal enactment, it may be better to pursue such a policy. In many instances, it is believed, such will be the case.

PART THREE

FEDERAL AND STATE AID

CHAPTER IX

THE RELATIVE PLACE OF SUBVENTIONS AND TAX SHARING

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The introduction of the state-collected locally shared tax was a logical step in tax reform. From a tax system based on the locally administered state shared property tax the first step was a separation of sources in which the property tax was left to local governments and new taxes were introduced to finance the state government. The rapid growth of local expenditures, together with the increase of taxpaying ability not associated with property and not readily reached through locally administered taxes, gave rise to a demand that the newer state taxes be shared with local governments. This demand was reinforced by the political necessity of providing localities with substitute revenues for those lost through the exemption or low rate taxation of certain kinds of property, and in recent years through rigid limitations on property tax rates. Professor Hutchinson in 1931 found 142 shared taxes in 44 states.[1]

Even before the rapid development of shared taxes, subventions or grants-in-aid had been employed, particularly in the field of education. The demands that gave rise to shared taxes could be met also by subventions, which in addition to assisting localities could be used to stimulate

[1] Ruth G. Hutchinson, *State-Administered Locally-Shared Taxes*, p. 126.

them in performing or expanding functions of state-wide importance.

The state aids of these two types made to local units of government in 1935 have been estimated at $1,066,000,000, which was 28 per cent as much as the $3,809,000,000 raised in the same year from local taxes.[2] A quarter-century before, in 1912, state aids amounted to $119,000,000, or 9 per cent as much as the $1,329,000,000 yielded by local taxes.[3] State aids have thus grown rapidly both in amount and relative to local taxes.

Of the total state aids paid in 1935, $293,000,000 or 27 per cent was the local share of state-collected taxes, the other 73 per cent being subventions. The percentages were almost identical with those of 1912. Shared taxes, however, had reached 41 per cent of the total in 1928. The amount of shared taxes was somewhat larger in 1935 than in 1928 but subventions increased to a greater extent. The resulting relative decline in the importance of shared taxes after 1928 may have been due to reduced tax yields during the depression and not to a genuine trend towards subventions. Evidence pointing to this conclusion is found in the sharp increase in the local share of state-collected taxes from the 1935 figure to $430,000,000 in 1936.[4]

Attitudes Toward Shared Taxes

Shared taxes have been approved by many students and writers during the past several decades. State tax sharing has indeed been more or less taken for granted. Professor Seligman from an early date recommended a combination of separation of sources and tax sharing as the best solution

[2] Carl Shoup, Roy Blough, Mabel Newcomer, *Facing the Tax Problem*, p. 577.

[3] *Ibid.*

[4] *Ibid.*, p. 578.

of state-local fiscal problems.[5] Both the first and second committees of the National Tax Association on a Model System of State and Local Taxation took the position that so far as the general plan of taxation was concerned, sharing of the tax was immaterial.[6]

The use of Federally administered, state shared taxes has been recommended as a method of solving the problem of conflicting taxation. As early as a quarter century ago, Professor Seligman was making this recommendation, at the same time opposing subventions.[7] More recently the Graves-Edmonds plan of fiscal relations proposed Federal administration of a manufacturers' excise tax and of liquor, cigarette, and gasoline taxes, the revenues of such taxes to be shares by Federal and state governments.[8] The Interstate Commission on Conflicting Taxation in 1933 recommended Federal administration and Federal and state sharing of liquor taxes.[9]

In the state of New York most of the tax investigation commissions recorded on the subject, with one as recent as 1935, have favored shared taxes.[10] It is accordingly both interesting and significant that the commission on state aid recommended in 1936 "that the sharing of all state-collected, locally shared taxes, with the exception of the

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[5] E. R. A. Seligman, *Essays in Taxation,* 10th edition, p. 387, 669, 677. The chapters dealing with the subject were written in 1910, 1915 and 1917.

[6] National Tax Association, *Proceedings of the 26th Annual Conference on Taxation, 1933,* p. 381.

[7] Seligman, *op. cit.,* pp. 387, 667.

[8] National Tax Association, *Proceedings of the 27th Annual Conference on Taxation, 1934,* pp. 165–167.

[9] The Council of State Governments and The American Legislators' Association, *The Book of the States,* Third Edition, Vol. I, pp. 89–90.

[10] This position was taken most recently in the *Sixth Report of the New York State Commission for the Revision of the Tax Laws, 1935.* For a summary of the positions taken by different commissions, see State of New York. *Report of the New York State Commission on State Aid to Municipal Subdivisions,* pp. 71–83. Hereafter referred to as New York Commission on State Aid, 1936. The section here cited is part of the memorandum of Mabel Newcomer and Carl Shoup.

motor vehicle license and motor fuel taxes, be abandoned."[11] This recommendation was not completely unheralded. Shared taxes have been under suspicion in New York for some years. In 1931 Professor Hutchinson of Vassar wrote much more favorably of subventions than of tax sharing, although she did not condemn sharing in all cases.[12] In 1932 Professor Haig and staff in a memorandum to the New York State Commission for the Revision of Tax Laws, recommended the strengthening of subventions and the reducing of shared taxes, especially if local government reform were accomplished.[13] In 1934 Dr. Hinckley, writing as a New York State Fellow in Taxation at Cornell University, suggested the desirability of eliminating shared taxes except for highways.[14] Professor Newcomer showed distinct preference for subventions in an address given before the 1936 Conference of the National Tax Association.[15] Objections to shared taxes have of course been raised elsewhere. The conflict of opinion in New York indicates that the choice between subventions and shared taxes is an important issue today.

Purposes of a State Aid System

The test of a fiscal policy is obviously the extent to which it accomplishes the results desired without having other undesired consequences. The purpose of the present paper is to examine the suitability of shared taxes in achieving the various purposes for which state aid is given. The terms "shared tax" and "subvention" are used here as they have

[11] New York Commission on State Aid, 1936, *op. cit.*, p. 10.

[12] Hutchinson, *op. cit.*, pp. 134–136.

[13] State of New York. *Report of the New York State Commission for the Revision of the Tax Laws, 1932,* pp. 210–212; New York Commission on State Aid, 1936, *op. cit.*, pp. 79–80.

[14] Russell J. Hinckley, *State Grants-in-Aid,* pp. 54–55.

[15] Mabel Newcomer, "Revenue Sharing Between Federal and State Governments and Between State and Local Governments," *Proceedings of the 29th Annual Conference on Taxation, 1936,* pp. 275–282.

been defined in the past few years, although with the understanding that there is no clear, dividing line between them. Professor Newcomer's definition of shared taxes as "state-administered taxes of which a fixed proportion is returned to local governments, regardless of whether the use is limited and regardless of the basis of distribution," and of subventions or grants-in-aid as "distributions to underlying governments the amount of which is determined by some other factor than the yield of specific taxes,"[16] seem adequate for use here.

Purposes that may be present in the adoption of a state aid program are of two main types, (1) to render financial assistance to the local community, and, (2) to exercise control over its activities. The purpose to render financial assistance may be either to aid a locality to tap its own resources, or to aid it by giving it revenues collected from the resources of other localities, thus achieving a redistribution of revenues. Control purposes may be of several kinds: to insure uniformity in the rate and administration of some tax; to induce an increase in the amount spent for a specific function (or conceivably, although not probably, for functions in general); to induce a decrease in the amount spent (although apparently state aids to accomplish this result have not thus far been developed); to set standards for the quality and kind of service rendered; or to increase the efficiency of the expenditure. The purpose may be negative as well as positive, that is, to render financial assistance without exercising control, and conceivably to exercise control with a minimum of financial assistance.

Return of Revenues to Source

While a subvention system might conceivably be designed that would, over a period of years, return revenues to their

[16] *Ibid.*, pp. 276–277.

source or locality of origin, this purpose is commonly achieved through the shared tax. Of the 142 shared taxes recorded by Professor Hutchinson, 71, or exactly half, were so returned.[17] In 1935, 57 per cent of the shared tax revenue was distributed in a manner designed to return it to the locality of origin.[18] Taxes that are shared for this purpose may be classified into two types. In the first type the rates imposed in the different localities are determined by the localities, and so differ from locality to locality. Tax distribution resulting from application of this method would come nearest to the results of local administration; in effect the state would be lending its superior administrative power to collect locally levied taxes. Such a system has been used to a considerable extent in France. It has been proposed for this country as a method of solving the tax conflicts between Federal and state governments. Under the proposal, the Federal government would administer certain taxes and pay the proceeds to the states according to rates imposed by the latter. A similar suggestion has been made that states might in some cases collect local license fees for localities. Certain difficulties would arise in applying such a plan of state tax sharing on a general scale. The lack of uniformity of tax rates in different local jurisdictions would prevent attainment of some of the advantages of simplicity that are possible under state administration, and would also lead to serious tax competition among localities, the elimination of which is one of the purposes of state administration.

State-collected locally shared taxes, even those returned to source, have almost universally been of the second type, which are imposed at uniform rates in all localities. Uniformity and administrative simplicity are thus promoted,

[17] Hutchinson, *op. cit.*, p. 126.
[18] Newcomer, *op. cit.*, p. 280.

but other serious problems are raised. One of these is extreme unevenness in distribution. When a shared tax is intended to replace revenues lost by localities through the repeal of some other tax, as when the Wisconsin income tax law was passed in 1911, the new shared revenue never has the same distribution by source as the displaced revenue had, so that some localities gain and others lose. The unevenness of distribution of shared taxes sometimes gives absurd results. In Wisconsin of the $500,000 of corporation income tax returned to 1279 towns (not villages or cities) in 1926, 67 per cent went to 3 towns.[19] One town in Wisconsin out of 698 containing public utility property had 30 per cent of the total value of such property located in towns.[20] Under the inheritance tax law of Ohio, 50 per cent of the tax goes to the township, village, or city where it has its "source", which according to an opinion of the Attorney-General is where the transferred property would have been subject to property taxation. One village received so much from the tax in a recent year that it had the legislature change the law so that part of the tax might be turned over to the local school district.

Such illustrations could be multipled endlessly. The inequality of distribution due to sharing a state tax of uniform rate may be undesirable for a number of reasons. First, it tends to cause tax colonization. The wealthy Milwaukee business men who formed a colony in a small rural town of a neighboring county and established their residences there were hardly unaware that the income taxes distributed to the town would permit extensive public improvements and very low property tax rates. The refusal of a small suburb of Milwaukee to be annexed to the city

[19] J. Roy Blough, *The Geographical Problem in Wisconsin Taxation,* p. 37.

[20] *Ibid.,* p. 39.

was probably not unaffected by the fact that a large utility generation plant was located in the town, on account of which large amounts of state-collected taxes were distributed to the town. And even the concentration of wealthy people in the Ohio village may not have been without reference to the provisions for distributing the inheritance tax. Certainly tax colonization frequently occurs, disturbing normal economic activity and resulting in tax avoidance.

A second consequence of very unequal distribution of shared tax revenues is the tendency to extravagance in communities receiving more funds than they have real need for. Even if they do not receive more than they can use, the revenue received relaxes the pressure against spending exerted by high local tax rates, especially when the local share of state-administered taxes is large.

A third consequence of inequality in distributing shared taxes is the variation produced among localities in regard to the distribution of the tax burden. Different taxes are paid to a considerable extent by different economic groups. Consequently, when the rate of one tax is fixed the same for all localities while the rate of another tax varies, the relative tax burdens borne in various localities by different economic groups will vary from locality to locality. If the distribution of the tax burden among economic groups is optimum in one locality, distributions in other localities cannot be.

Not only is the revenue distributed very unequally in comparison to expenditures and local tax bases, but it may vary widely from year to year. Such variations make accurate budgeting difficult if not impossible for local districts. Financial plans for the year may be thrown entirely out of joint by a deficiency in shared tax revenue, and to a less degree by a large excess of revenue over the amount anticipated. Localities lack the flexibility of central gov-

ernments in securing new revenues. Being limited largely to the property tax, they are subject not only to the economic limitations on increased rates but also to what are frequently rigid political restrictions in the form of tax rate limits. When shared tax revenues cannot be counted on in stable amounts they are often looked on as extra revenue and spent on less important objectives, a tendency that promotes extravagance.[21]

Another difficulty in returning revenues to their "source" is that the choice of a tax to share determines what local jurisdictions will receive the bulk of the revenue. Different taxes are concentrated differently among localities. Thus Milwaukee City for 1928 had proportions of total tax bases in the state varying from 22.7 per cent for motor vehicle licenses to 60.8 per cent for the inheritance tax.[22] Since some state taxes are shared, while others are not, it is more or less a matter of chance whether a given locality will receive much or little shared revenue.

More serious than these difficulties, perhaps, is the fact that the localities recognized to be the "source" or "origin" of shared taxes to which such taxes are returned, are frequently not true sources, with the consequence that the tax sharing is in effect a redistribution of the taxes by taking them from one locality and giving them to another. Redistribution is, of course, present in all subventions as well as in those shared taxes that are not distributed to "source", but in such cases it is deliberately done with a specific purpose in mind, and the expenditure is ordinarily so controlled as to advance the best interests of the whole area. Redistribution of shared taxes to "source", where the nominal source is not the real one, however, is unintended redistribution and often in a direction opposite from what

[21] See New York Commission on State Aid, 1936, *op. cit.*, p. 11.
[22] Blough, *op. cit.*, p. 32.

would be deliberately undertaken, while the expenditure is not controlled and does not bear any necessary relation to the best interests of the whole area.

Determining the "source" or "origin" of a tax involves two related problems, one the determination of what jurisdictions have just claims to the tax, the other the determination of how much should go to each claimant jurisdiction. Courts and legislatures often take the easy way out by attributing a tax base to the jurisdiction where administration will be the easiest, or even to the jurisdiction where political power is the greatest. It would appear, however, that at least all of the following have some claim to the revenue from a tax, whether the tax base be property, gross sales, net income, transfers at death, or business franchises.

1. The jurisdiction of residence of the actual or equitable owner has a claim to his taxes, since it expends funds in rendering services to him and since the tax base is part of the economic situation determining his ability to pay taxes.

2. The location of the physical property has a claim, since the jurisdiction protects it.

3. The location of the business operations has a claim, since the jurisdiction protects it and makes possible its operation.

4. The locations of customers, workers, or others to whom part or all of the tax are shifted have claims.[23]

When all the above elements giving rise to tax claims are located in the same jurisdiction, no conflict arises, but when they are in different jurisdictions, as they are increasingly, the jurisdictions are competitors for revenue. No attempt will be made here to answer the question of

[23] To some readers such claims may seem far-fetched. The claims would seem to have validity when the amounts of the shifted taxes are greater than the value of the taxing government's services as an element in the productive process.

how the yields should be shared among the competing jurisdictions, but it should be obvious that any arbitrary determination of taxing jurisdiction does not accurately indicate the origin of the tax.

Although the competition of jurisdictions for revenues takes place for all tax bases, it is in general more serious in the case of those kinds of taxes that are administered by central governments. One reason why such taxes are not suitable for local administration is that they are commonly based on business, which pays little attention to jurisdictional boundaries and may extend into numerous localities. Allocation of tax bases of going business concerns that operate in many jurisdictions must at best be largely guesswork. Accordingly the sharing of taxes to their "source" is at least for most taxes a rough process. Local imposition and administration of a tax necessitate the arbitrary determination of taxable situs, which may be justified because of the encouragement to local taxing responsibility; but when the central government imposes and administers the tax at uniform rates, the social values gained by local responsibility are absent, and arbitrary allocation is more difficult to justify.

Redistribution of Revenues

For about half of the shared taxes and for subventions generally, one of the intended results is a partial redistribution of tax revenues among localities. For achieving redistribution, subventions are superior to tax sharing. Justifications for redistribution are pure philanthropy on the part of wealthy areas and the fact that certain activities of localities are of wider than local interest.[24] Redistribu-

[24] Redistribution to correct errors in allocating the jurisdictions of localities to tax, while ideally possible, and perhaps a motive existing in some cases, is administratively impracticable.

tion for these purposes requires some measurement of local need for the activity in question. If more equalization of tax burdens is desired than a fixed matching subvention or grant gives, thus necessitating variable grants, the measurement of relative local fiscal capacities is also necessary. Tax sharing on the basis of need, or of need combined with fiscal capacity, is difficult to achieve since the annual variations in tax yield bear no relation to the amount of need.

Again, since the purpose of redistributing revenue is ordinarily to assist in the financing of functions that have a state-wide interest as distinguished from those that have a purely local interest, the state aid funds are usually allocated for specific purposes. The allocation of a share in a specific state tax for a special purpose has the same weaknesses as have all earmarked taxes. Earmarked taxes make administration of expenditures difficult since accurate long-term planning is impossible. Such taxes are likely to give a feast or famine; a function may have more than it needs at one time and less at another. Functions supported by different revenue sources will fare differently without regard to merit or need. Once begun, the allocation of a tax for a particular purpose tends to be perpetuated since people come to accept it as though some natural and necessary relation exists between the yield of the tax and the expenditure. The use of the allocated tax thus tends to cause unbalanced support of functions. A popular project may secure a strangle-hold on a source of revenue and keep it because of momentum and vested interests, with the result that other more important functions are neglected. Such difficulties extend to shared taxes and make them generally unsuitable as a method of financing specific functions.

The benefit taxes, for example motor taxes imposed to finance highways, present a somewhat different situation

since they should properly be allocated to the performance of the function that produces the benefit. Even here, however, the difficulties arising from the tax sharing device are such that it may be more desirable to place the revenue in a state fund and to grant annual amounts to localities on the basis of need than to share the yield of taxes annually. To the extent that it is desirable to make localities bear the burden of revenue changes, appropriations may be increased or decreased. Such changes are usually made at the beginning of a biennium or not less frequently than each year, and save the locality the difficulties arising from unexpected month to month variations in revenue. The state, as previously pointed out, is in better position to stand revenue variations than are localities.

Control of Local Activities

For control purposes, subventions are clearly superior to shared taxes. The amount and method of distribution required to stimulate the desired local action can be realized much more accurately through the subvention. Furthermore, the control is ordinarily weaker in the case of the shared tax since the receipt of shared tax revenue apparently seems, at least to local officials, more a matter of right than does receipt of the subvention. Indeed, a frequently acclaimed merit of the shared tax is that it permits more local autonomy and results in less centralization of power than does the subvention. This is probably true, but if assistance without control is desired the block grant seems in most respects superior to the shared tax. The amount of the block grant can be adjusted to the needs and resources of a locality. If the block grant is carefully adjusted to ability and need, extravagant local expenditure is less likely to occur than with the shared tax, since the receipt of unneeded amounts by localities and the demoralizing varia-

tions in revenue from month to month and year to year are avoided. The tendency, however, for the central government to exert control is probably greater with the block grant than with the shared tax.

If the purpose of having a tax administered by the state is merely to improve the administration of the tax and to insure uniformity in rates and administration, there is little choice between tax sharing and the placing of the proceeds in the state treasury to be distributed as subventions. In case local officers retain some function in tax administration or in checking evasion—as might be the case in the motor vehicle license tax—they would presumably perform their functions better if the local share of the revenue depended directly on collections.

Summary and Conclusion

It appears, in summary, that the shared tax is superior to the subvention when revenues are to be returned to the locality of recognized origin, when avoidance of central control is desired, and possibly when benefit taxes are distributed. For all other state aids the subvention appears to be superior.

In the field of Federal-state relations those people who believe that the autonomy of the states must not be further impaired will probably prefer a tax sharing system to a large development of subventions. The use of Federally administered, state-shared taxes on a moderate scale would not be objectionable to the same degree as are state-administered, locally shared taxes. The states are large enough units not to be likely to be flooded with unneeded revenue, and the fluctuations in the shared revenues would perhaps be no greater than in state-administered taxes.

Since the return of state-administered taxes to the localities in which they have actually their source is in general

an impossibility, the presumption is strong that a central government might well base its policy on a subvention system, assisting in the financing of functions that are of interest not only to the locality but over the whole area of its jurisdiction. A logically corollary policy is to leave to local governments all taxes that they are competent to administer so that they may have funds to finance functions that are of purely local interest. A similar system of policy may seem to many to be superior to shared taxes in the field of Federal-state relations.

The undesirability of shared taxes grows progressively with the proportion of local revenue derived from them. So long as the proportion is small—as it is at present in most localities—the difficulties are not likely to be significant. If, however, as appears likely, the central governments raise an increasing amount of revenue for distribution to local units, the undesirable effects of the shared tax may become very important indeed. It would be wise to anticipate and prevent an undesirable future situation by setting up financial arrangements that will continue satisfactory as the magnitude of the state aids increase. Otherwise important vested interests are likely to be created that will prevent desirable changes in policy when they are imperatively needed.

CHAPTER X

THE BASIS OF SHARING TAXES

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The problems considered here today—shared taxes, grants-in-aid, central-local fiscal relations—assume significance only in advanced industrial civilization. Undeveloped economic society is not concerned with them. Its governmental requirements are small, the bases of taxation utilized by its various political jurisdictions are identical, and it accepts proportionality as the criterion of taxation. In such society the distribution of the tax load among the various categories of wealth and income, as well as the allocation of the tax resources and the public services among the various governmental levels, is of no consequence. As the national economy progresses, however, central-local fiscal problems develop; and the more numerous the governmental authorities covering the same geographic area, the more complex this development.

Central-Local Fiscal Relations Inevitable

The nature of advanced economic civilization and the complexity of governmental organizations render the appearance of central-local problems inevitable. Some are inherent in accepted notions of fiscal desirability; others are a necessary consequence of the social, economic and political process.

Theoretical Considerations

In the modern economy, public revenue invariably lags behind requirements. It therefore becomes doubly important to relate the sacrifice represented by taxes raised to the benefit derived from public funds spent. Because of its magnitude, it becomes essential to allocate the tax burden equitably among the various tax bases and to budget public funds judiciously among the various claimants. In a federated state this calls for a prescribed division of functions and resources among three or more governmental levels. The division is prescribed by the self-evident maxim that taxes be collected by the unit of government which can do so most effectively, and that functions be performed (i.e., the public moneys spent) by the unit of government which can do so most efficiently.

Compliance with this twofold prerequisite of good fiscal practice, however, is likely to produce disequilibrium. The distribution of the tax burden among the various tax bases in accordance with accepted standards of equity and the placing of these bases at the disposal of those governmental levels best equipped to impose that burden effectively, may produce a distribution of revenue which will be at variance with the distribution of revenue requirements determined by the proper allocation of public services. The allotment of revenue in relation to revenue needs inevitably will be excessive in some and deficient in other governmental levels, calling for central-local fiscal readjustment.

While at any one time the distribution of revenue sources may conceivably harmonize with the costs of public services, a lengthy continuance of that equilibrium is highly improbable. Not only will the costs of the several functions and the productivity of the several tax bases develop unevenly, but new tax bases and new service requirements are

certain to come to light. The constant pressure for revenue will affect the different bases unevenly, disturbing further the equilibrium between the tax resources and the revenue requirements of the various governmental levels. On the whole, the superior government will claim more and more of the tax bases. Centralization of tax resources will occur more rapidly than the centralization of governmental functions. Simultaneously, local functions will grow increasingly costly while the sources of local revenue continue to be seriously hampered by inflexibility. All these forces will add to the complexity of financial readjustment,—to the task of those striving for an equitable central-local fiscal structure.

Pragmatic Considerations

The need for financial readjustment, however, does not arise from these abstract and theoretical considerations alone. It may and, in fact, more often does arise from fiscal developments of a pragmatic and opportunistic character. It may, for instance, arise from the centralization of a local tax base, such as corporate property, the resulting reduction in local government revenue creating a need for fiscal readjustment. It may arise out of legislative action to provide relief to a specific tax base upon which a particular level of government had previously depended for revenue. It may arise out of the decision to afford financial assistance to a functional group, locally financed, in exchange for its support of specific fiscal legislation. And it may arise either because the central unit of government undertakes to encourage a particular local governmental function or makes local expenditure for such function mandatory, or, conversely, because a function previously performed locally now requires central administration. Finally, it may arise because two or more levels of govern-

ment assess the same category of wealth, income or business activity, without regard for one another's interests. In such instances, integration through such a device as the shared tax offers a possible course of action. It has the potentiality of eliminating wasteful duplication of tax administration and costly repetition of taxpayers' compliance, without unduly disrupting the distribution of revenue. Illustrations of each of these and similar fiscal contingencies will readily suggest themselves.

These two aspects of the problem of fiscal readjustment, the theoretical and pragmatic if you wish, while similar in many respects, must, nevertheless, be distinguished from each other. The first, which is characterized by the quest for the most effective use of all public funds, calls for the equalization of revenue needs and fiscal abilities with reference to all governmental units; the second, for adjustments calculated to attain more limited fiscal ends. In practice this distinction resolves itself to one between equalization with respect to all governmental functions and equalization with respect to one particular governmental function. That actually the first is the less common is but an illustration of the prevalence of pressure groups. Consider, for instance, the prominent rôle of school, road, welfare and realty groups in recent state tax legislation.

Viewed economically, the practice of piecemeal fiscal readjustment in central-local relations is cause for concern. In the final analysis, equalization of fiscal ability can have fundamental significance only in relation to the whole gamut of governmental functions. Equalization with respect to one governmental function borders on the meaningless. If two units of government have identical abilities to raise revenue for all governmental purposes but have unequal needs for any one of the legion of governmental functions, the burden represented by equal contributions for any

particular governmental function is not the same; the net abilities of the two governmental units are, in fact, different. Two units of government possessing identical complements of financial resources but requiring unequal sums for public health, public welfare, or education have unequal abilities to finance all other governmental services. Persistent fiscal readjustment with reference to individual functions or individual tax bases can lead only to injudicious distribution of public funds between public services and unequal distribution of assessments between tax bases.

Methods of Financial Readjustment

Redistribution of Functions

Readjustments in central-local fiscal relations provoked by such considerations as those enumerated above may take any one, or any combination, of several forms. One of these is a redistribution of governmental functions. If, because of one reason or another, local revenue becomes inadequate, the central government may assume financial responsibility for a governmental function previously financed locally. Theoretically, the possibilities of such a procedure are limited. If originally the function was properly allocated, its subsequent reallocation would conflict with the previously enunciated maxim that services be performed by those units of government which can do so most efficiently. To be sure, some public services may originally have been assigned to units of government not best able to perform them. In the case of others, economic development may itself call for reallocation of functions, which previously could well be performed locally, but which have since grown to require central attention. Possibly, too, some functions can be performed equally well by two or more governmental units. On the whole, it would be unfortunate if the

cause for reallocation of governmental functions was financial need rather than the administrative inability of the governmental unit now in jurisdiction. At all events, whether redistribution of governmental functions can ever assume major proportions in central-local fiscal readjustment will depend, of course, upon the success with which one category of vested groups, the public officials now in jurisdiction, can be dislodged. While restricted, these possibilities occasionally assume significance in relatively undeveloped functions. The field of public welfare is a timely American illustration.

On the other hand, the extent to which state assumption of functions hitherto financed locally releases corresponding ability to provide funds for other purposes is subject to conjecture. Experience tends to indicate that the local governmental structure is too inflexible to permit a ready redirection of such resources.

Sharing of Functions

Fiscal readjustment can also be effectuated through the sharing of functions. Conceivably, particular governmental services may be financed jointly by two or more governmental units, and this with sufficient comity to produce a creditable result. Comity, however, is not infrequently lacking. Consider recent experience with the division of financial responsibility between the Federal Government and state and local governments with respect to the relief of the employable and the unemployable unemployed. Such, too, may be the inference from the present lack of harmony between the Federally assisted social security and the Federally unassisted general relief programs. Limitations notwithstanding, however, the practice is common in the American states.

Local Additions

On the revenue side, fiscal readjustment may take the form of local assessments coupled with central collection of revenue. This device, frequently referred to as central-collection with local additions, may be at variance with the proposition that the distribution of tax burden in accordance with preconceived standards of equity can be achieved only through coordinate action. Where, on the other hand, the required coordinate action is attained by centrally imposed limitations upon local additions, the essential character of the device itself is largely sacrificed.

Redistribution of Revenues

Central-local fiscal readjustment may also be achieved through a reallocation of tax sources. At the outset, cognizance must be taken of the possible conflict of such a procedure with the initially stated principle that taxes ought to be collected by that unit of government which can do so most effectively. Here again the tax base may originally have been assigned to the improper level of government or, since its original assignment, economic development may have created the need for reassignment. This, not unlike some of the previously enumerated devices, however, is more suitable for enhancement of central rather than local resources. The one remaining base adaptable to local administration, real property, offers little possibility for expansion.

Respecting all the above enumerated devices of fiscal readjustment, sight should not be lost of one major limitation. With the possible exception of an unrestricted system of local additions, they are unsuited for the making of such financial readjustments as may be required to affect individual units of government within any one governmental

level. Their application is strictly limited to adjustments between governmental levels. This quality differentiates all of the above from two which still remain to be discussed —shared taxes and grants-in-aid. Collectively, these six encompass the more important possibilities of fiscal adjustment between central and local governments. Where they fail, a sacrifice in the quantity or quality of public service is the only alternative.

Shared Taxes and Grants-in-Aid

Both, shared taxes and grants-in-aid, involve the transmission of funds from one level of government to another for general or restricted purposes. They differ in the character of their end products. A shared tax usually involves the transference of fixed proportions of a centrally administered tax, with the result that the amounts distributed depend upon the yield of a specific tax. The grant-in-aid also involves inter-governmental transfer of centrally collected revenue, but the amount so transferred may and generally does depend upon some other factor than the productivity of a specific tax. The degree of the recipient government's participation in the fortunes of tax collections is thus noticeably greater in the one case than in the other.

The fluctuating productivity of shared taxes constitutes one of their major deficiencies. A variable source of revenue is not only conducive to waste, but is also destructive of fiscal planning. From the point of view of the central government, the opportunity to pass on part of the risk of poor collections to the inferior governmental level is advantageous, to be sure, notwithstanding the limitations which confront the latter in its efforts to compensate for these losses with other revenue sources.

Discussions of the bases of distribution generally make

much of the distinction between shared taxes and grants-in-aid. The profitableness of such endeavor, however, appears to be doubtful. Contrast, for instance, a state corporation income tax shared with local units on the basis of scholastic population with a grant-in-aid for highways, distributed on the basis of automobile registration. The basis of the shared tax in this instance approaches that of a grant-in-aid, while the grant-in-aid is, in fact, distributed on what might be a collection basis for a shared motor vehicle tax.

I have dwelt at this length upon the rôle of shared taxes and grants-in-aid probably longer than the announced title of my paper may have led you to expect, because it is indispensable to the discussion. The bases for sharing taxes, the subject assigned me, cannot, it would appear, be discussed in the abstract. There is no theory of tax sharing which is not at the same time a theory of grant-in-aid allocation.

Considerations Governing Distribution

From the point of view of central-local fiscal relations, the fundamental difference is not one between shared taxes and grants-in-aid, but rather one between basic readjustment affecting the whole fiscal canvas as opposed to readjustment directed to achieve a restricted fiscal end. In the quest for the optimum in fiscal economy, these two devices offer no choice. They can and should be made to complement one another to facilitate the most effective use of public funds. If, on the other hand, one is concerned with such perplexities as home rule and local financial independence, the complexity of the problem is merely enhanced by the addition of other variables. To be sure, that variable cannot be disregarded, for the judicious allocation of public funds may require effective local control.

While much of the recent discussion in central-local fiscal relations has properly concerned itself with the merit of local financial independence, that aspect of the problem is here ignored. It may not be out of place to observe, however, that greater emphasis upon public personnel and related problems may minimize the importance of these considerations.

The similarities of shared taxes and grants-in-aid are fundamental to an examination of the bases of sharing. In the final analysis the bases for revenue distribution, whether through shared taxes or grants-in-aid, will be conditioned by the results they are intended to achieve. Here reference is made to the distinction between fundamental fiscal revision and revision calculated to achieve some limited fiscal end. With respect to the bases which should govern the first of these, it need merely be observed that financial readjustment must be such as to equalize within the general welfare sphere the revenue requirements and financial abilities of the various categories of governmental units. This objective would involve: first, the distribution of the tax burden among the various tax bases in accordance with accepted standards of equity; second, the distribution of these tax bases in accordance with the abilities of the various governmental levels to administer them; third, the distribution of governmental functions with a view to the same end; fourth, the redistribution of revenues by such devices as grants-in-aid and shared taxes; and, finally, an equalization of the structure by harmonizing financial resources as measured by acceptable standards of fiscal ability with revenue requirements as reflected by approved standards of service units and unit service costs.

In the theoretically ideal structure of the type just indicated, shared taxes and grants-in-aid can each play their part. Not only can shared taxes advance the cause of

equalization, but they may be employed in fundamental fiscal reorganization itself. Thus, they may take the place of objectionable tax limitations in those cases where an unequal distribution of local tax bases leads to extravagance in wealthy communities and to a deficiency of funds in poor communities. The shared tax device may here be employed to divert excess funds from one category of unit to the other. To the extent, however, to which the varying yields of shared taxes create fluctuating divergences between financial needs and abilities, they enhance the equalizing tasks of grants-in-aid.

With reference to the bases which govern sharing (as well as grants-in-aid) on those occasions where the objective is more restricted, where it is concerned with the elimination of particular inequities, no categorical answer can be given. In these instances, the particular circumstances of the case, not too lightly weighted with political considerations, will prescribe the distribution bases. That the possible variations here are legion can be readily observed in existing state and local fiscal relations.

Existing Bases of Distribution

No attempt will here be made to present a detailed catalog of the numerous state-local fiscal devices now in existence in the United States. Professor Newcomer's various analyses of the subject, particularly that presented last year to the National Tax Association, and the summary tabulations of Raymond Uhl and Anthony Shea, Jr., published in the 1936 edition of the *Municipal Year Book,* are sufficiently up to date. Analyses along functional lines are also abundant. State-local relationships in the fields of education, highways and welfare have been analyzed in particular detail. In view of this ready availability of information, the remaining portion of this paper will be

restricted to such examples of existing fiscal devices as will be illustrative, rather than exhaustive, of the problem.

Distribution of Relief Funds

Let us, for instance, observe the exceedingly active field of unemployment relief. It illustrates abundantly the opportunistic character of central-local fiscal relations. The problem, as many of you have cause to know, concerned the financing of a public function which prior to the recent depression had been considered an exclusively local responsibility.

While limited to but five or six years, the record of the allocation of relief funds between local governmental units is significant, for it culminated two hundred years of American experience with central-local relations. The fact that in some cases state relief financing took the form of shared taxes, in others grants-in-aid, and in still others state assumption of functional responsibility, is of no consequence. The problems of devising bases of distribution were identical.

The outstanding feature of this nation-wide experience is the discretionary nature of the distribution of state relief funds among local governmental units by administrative authority. The legislatures were reluctant to write distribution formulæ into the appropriation acts. Those states which had recourse to such restrictions found it necessary to guard against inequities by providing supplementary discretionary funds. Caution of this nature is particularly telling, because all these states had the assurance that if the distribution of their own (state) funds produced inequities between local units, adequate Federal funds were always available to re-establish equilibrium.

The bases for the distribution of relief funds had to be such as to equalize differences between local relief needs

and local abilities to relieve those needs. These two problems, the measurement of local need and the measurement of local ability, constitute the bugbear of central-local fiscal relations.

In the case of relief, need is the function of two variables, the number of those destitute and the requirements of each. These are relativly precise concepts. Their precision notwithstanding, the methods employed for their measurement were numerous, reflecting variations in the concept of need not only between communities but between individuals within the same community. Some states measured need on the basis of the relief case loads or relief expenditures during some specific period within the immediate past, and exposed themselves to the danger of perpetuating such intrastate inequities as existed at any one time in the extent to which need was relieved. Such a procedure, furthermore, presupposed not only that need had been met with uniform adequacy in all units during the chosen base period, but also that its subsequent fluctuations had been uniform throughout the state. The applicability of past expenditures as a criterion of need can be summarily dismissed by the observation that they reflect the availability of public funds more often than public requirements.

Some states assumed relief needs to vary in proportion to population and thus ignored the existence of wide variations in the proportions of the population in need and in the degree of destitution. Other states experimented with the measurement of need by unemployment statistics. In their instance not only were the statistical data inadequate but the methodology was faulty, for it assumed the existence of a direct correlation between the number of those eligible for assistance and the number of unemployed. The lack of standardization in definitions of unemployment is notorious. Further, the procedure overlooks the fact that

the extent of need varies with the duration of unemployment as well as with the status of the individual's personal resources. The longer the period of unemployment and the lower the normal wage earning capacity, the more probable the existence of need.

Time does not permit a detailed listing of all the alleged standards of relief needs employed. Suffice it to observe that most states had their own conception of what constitutes a measure of need.

Turning to the measurement of local abilities to finance relief needs, the variations are even more pronounced. Here the first thing to be observed is the general failure to recognize the relation of local ability to finance relief to the ability of the local units to raise revenue for all governmental functions. Relief was segregated as a function unto itself. Recourse in general was had to simple unsatisfactory criteria. The importance of property in the local tax structure frequently led to the conclusion that the abilities of the political units are adequately reflected by some statistical aspect of the property tax. Some measured ability by the assumed yield of a fixed property levy; others by assessed valuation. Others attempted to refine the process by recognizing variations in degree of tax delinquency. Unfortunately, experience with all these devices is too recent to establish definitely whether they tend to subsidize inefficient and penalize good tax administration.

Several states related local ability to borrowing capacity, to unused borrowing authority or marketability of securities. The more progressive states carried the analysis outside the fiscal to the more general economic realm. Wealth, individual income, automobile registration, gasoline consumption, retail sales, and agricultural, mining and manufacturing production series have all had their day in court. Yet out of this whole experience, affecting every state in

the Union and involving hundreds of millions of dollars, one conclusion stands out predominantly: central-local fiscal relations are the product of a maze of local forces not readily reducible to common denominators. In consequence, financial readjustments ignore basic objectives and are everywhere determined empirically as circumstances require. At best, those concerned with bases of distribution begin with definite notions of desirability and strive for those criteria which most closely approximate their preconceptions, without at the same time doing violence to the requirement that a system of distribution must at least have the appearances of scientific profundity.

Distribution of Sales Tax Revenues

Analysis of distribution methods employed with reference to individual taxes reveals a similar lack of universality. Here, too, the bases of distribution reflect specialized local circumstances rather than standardized scientific principles. Consider, for instance, the sales taxes, which have especial significance because of their recent origin. They are significant for another reason as well. Legislators generally display little enthusiasm for sales taxes. In consequence, their enactment could frequently be effectuated only with the support of specific pressure groups; and pressure groups are not motivated solely by the quest for good government!

The first thing to be observed here is the coincidence that the twenty-four sales tax states include those in which property tax limitations have been most severe and which therefore have turned to the sales tax to make up in whole or in part revenue lost in property tax reduction. Indeed, the state whose tax limitation has been much publicized, West Virginia, imposes a twofold sales tax, one on gross income and another on retail sales.

Since the property tax limits are more restrictive of local

than of state revenue, the substituted income from the sales tax is in large measure redistributed for general or functional local use. Such allocation takes diverse forms, of which direct allocation to local units is the exception. Direct sharing of sales tax revenue with local units in excess of 50 per cent of collections is found in only two states, although smaller proportions are so redistributed in five additional states. Where it does occur, the sharing is based on such criteria as population, area, scholastic census, assessed valuation and tax collections or is distributed equally among all units within a specified governmental level.

The significant redistribution occurs through the financing of two functions, education and public welfare. In nine states over half of all sales tax revenue is dedicated to public school support and hence to the support of local units. In three other states allocations for school purposes, while small in relation to total collections, are none the less consequential. Equally important is the educational use of the tax proceeds credited to state general funds. Nearly all of the eight states which credit two-thirds of sales tax revenue to state general funds, as well as the six states in which general fund allocations are relatively less important, reappropriate a substantial share of these funds for local school financing.

Second in importance only to public schools is public welfare. While only three states allocate sales tax revenue to local relief and welfare, fourteen states dedicate a portion or all of the proceeds to state welfare activities. Of this number, three reserve at least half, and eleven less than half, of sales tax revenue for this function. The significance of this dedication does not lie so much in the fact that the sales tax is paying for a share of this increasingly costly

function, but that large shares of welfare costs are being transferred from the localities to the states.

It should be readily apparent that the statutory reservation of revenue for property tax reduction by five states is no more than a hint of the redistribution of the tax load accomplished either through the reallocation of state sales tax revenue to localities or through state assumption of functions formerly financed locally. The permanency of state sales taxes hinges more upon the need for sales tax revenues in conjunction with the reallocation of costs than upon any other factor. Probably, too, the basis of that reallocation will continue to vary from state to state as local forces, political, economic and social, chance to require.

Distribution of Death Tax Revenues

The share of local governments in sales tax revenue contrasts sharply with their share in the inheritance and estate tax collections. Taxes on transfers of property at death are accepted as necessary evils of modern civilization; their enactment arouses little opposition and hence requires little support of special groups. Inheritance and estate taxes are now in effect in all but one of the 48 states. Local sharing of revenue, however, is restricted to few instances. Where it exists, the basis of sharing is usually decedent's domicile. Only 9 of the 47 states share their death tax revenue with local units. The amounts so shared range from 5 per cent in one state and 7½ per cent in another to 65 per cent in a third. In three of these nine states the locality's share is restricted to specific functional purposes; in the remainder it accrues to local general funds. Mention, too, should be made of the fact that in four states, including one of the aforementioned eleven, death tax revenue goes to state-assisted local functions, schools and old age pensions. In 35 states, however, death tax revenue

is retained for general state purposes. This evidence tends to support the generalization that death tax enactment can generally be effectuated without the support of functional groups and thus creates no problems of distribution; unless perchance the conspicuous lack of sharing is a recognition of the principle that little is to be gained by the sharing of a tax whose yield is relatively unimportant.

Conclusion

This analysis might well be extended to other functions and other taxes. Such procedure, however, is not essential to the formulation of our conclusions. The bases governing the distribution of shared taxes are essentially identical with those governing grants-in-aid and centrally financed local functions. Theoretically, all three are but varying aspects of the same problem, the maintenance of equilibrium between the distribution of public functions and public resources. As such, it devolves upon them to facilitate the ultimate in fiscal economy: to relate the burden of public funds raised to the benefit of public funds spent; to facilitate the allocation of taxing devices to those governmental units which can administer them most effectively and to facilitate the allocation of public services to those governmental units which can perform them most efficiently; and, finally, to effectuate, within this framework, an equalization between intergovernmental needs as measured by acceptable standards of services and service costs and financial resources as measured by approved standards of taxpaying abilities.

Actual practice, however, is at substantial variance with theory. Shared taxes, not unlike their companionate devices, are generally employed to achieve more restricted ends. In such instances the bases of distribution are generally determined by prevailing circumstances, not least

important of which are political forces. A theory of tax sharing distinct from a theory of grant-in-aid distribution and possessing the quality of universal applicability is conspicuous only by its absence. The contemporary American shared tax is essentially a tailored device; tailored to the prerequisites of the time and the place.

CHAPTER XI

STATE AID GOALS

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HISTORICALLY speaking, the development of state aid in the American states is characterized by its virtually utter planlessness. Like the Topsy of Uncle Tom's Cabin, having come into life's picture, it "just growed," and as it grows like Topsy, becomes an ever increasing problem. Its evils have ofttimes brought anguish to its advocates and defenders. It has been a stubborn and recalcitrant child to rear. It is still growing and, unhappily, hardly less waywardly than formerly.

The term state aid is a general term improperly understood, if it has ever been adequately defined. It has been used to cover a multitude of sins in government, having on occasion been resorted to in defiance of all conscionable and logical principles of sound public finance.

Webster defines the word "aid" as (1) "the act or result of helping or succoring, or the means employed"; (2) "a subsidy"; (3) "a pecuniary contribution by a feudal vassal to his lord." We may reject as inapplicable the feudal definition, for the reason that state aid as known in this country certainly does not represent a pecuniary contribution from an inferior to a superior political authority, but quite the contrary. The word "subsidy" is hardly universally applicable in defining state aid, for the reason that some forms of state aid are anything but subsidization.

Nor is the term "subvention," which is frequently heard, sufficiently inclusive to accept without reservations. We are thus compelled to fall back upon the first and more general definition that state aid represents the act of helping or the means employed in helping local governments.

Thus defined, state aid takes a variety of forms. These I have classified as follows:

I. State-collected locally shared revenues
   (a) For specific purposes (highways)
   (b) For general purposes (capitation subventions)
II. State general fund appropriations to local units
   (a) For specific purposes (schools)
   (b) For general purposes (liquor profits)
III. State assumption of erstwhile local functions
   (a) In whole (highways)
   (b) In part but with enlarged central control (welfare relief)
IV. Separation of state and local revenue sources.

I am aware that in the preceding categorical listing I have opened myself to challenge by many competent authorities who have long studied this matter. They will properly say that this classification of state aid devices makes of things that which they are not. Yet I am prepared to offer illustrations of each item to show its adoption in a single state (Virginia) at one time or another as a specific method in aiding local governments where it was felt that local fiscal capacity was limited or inadequate. While these devices were not always tabbed "state aid," the arguments which resulted in their adoption spoke strongly of the "need for local aid." I do not wish to infer that these arguments meet with my approval or that in some cases they were anything but spurious, but I do wish to emphasize that legislative attention was paid to them and not always with salutary results.

Accident and expediency rather than deliberation and

judgment have dictated the courses and trends in state aid policies to date.

The most outstanding single factor involved in the rapid growth of state aid has been the taxation of real estate. State aid practices have developed primarily in order to relieve real property from taxation which already was carrying a disproportionate share of governmental costs. The property tax has been the bulwark of local revenue sources throughout the history of American taxation. As governmental services were enlarged and extended, local governments were compelled to lay additional levies on property. This situation, aside from the relative inequities and injustices which it engendered, actually worked to destroy the basis of the tax itself for the reason that over-burdensome rates on real estate operated to make investments in this field relatively unprofitable if not in some instances wholly so.

My task in this paper is to set forth the principles and objectives which connote a defensible program of state aid. In undertaking this, I am aware that I am dealing with matters which involve 48 major governmental areas and upwards of 150,000 subordinate governmental units. Much has already been done in this important matter which cannot be undone. It cannot be wholly inappropriate, however, to suggest things as they should be, especially since things as they are stand in need of intelligent planning and corrective effort.

Need as the Basis of State Aid

My first point is that any state aid device must satisfy the requirement of need.

In the United States a most dangerous psychology has developed in recent years. This psychology is that governmental authorities higher in the scale of territorial and

legislative power may be looked to for every additional fiscal need. This phenomenon relates not only to emergency needs but to the ordinary, regular, and customary activities of government. Thus, during the depression, state governmental authorities looked to the Federal authority for financing relief programs, presumably justifying their expectations on the theory that unemployment and widespread destitution were national problems. In similar manner, the local governmental authorities looked to the state authority to supplement such funds as were provided by the Federal Government. As to normal and regular governmental functions, evidence of passing fiscal responsibility to the higher level is seen in the Federal appropriations for roads, and more recently in the fields of agricultural stabilization and social security.

I would not have you infer that in citing these tendencies I necessarily condemn them. The point I wish to make is that it has been altogether too easy in the past to shift fiscal responsibility to higher governmental levels. This constitutes a danger primarily because it has been done with such ready acquiescence by the higher levels of government, and because the lower levels have failed in many instances to study through to the ultimate consequences attending such trends.

Imperative and commanding fiscal or social need should therefore represent the sine qua non precedent to shifting fiscal burdens from lower to higher governmental authorities. That is to say, state aid devices are admissible only (1) in instances where, and to the extent that, local governmental authorities do not possess adequate revenue-raising power, and (2) under circumstances in which for reasons of social control it is imperative that a given function be financially supported out of revenues raised through nonlocal sources. Examples of state aid devices justifiable

through local fiscal incapacity are state subventions for schools and highways. In the category of state aid prescribed on grounds of social control are monetary distributions to localities of liquor profits under state-administered alcoholic control systems.

Method of Awarding State Aid

The second major point I would make concerns itself with selecting the method of awarding state aid. In this connection much depends upon the circumstances and conditions which give rise to the need for aid. We have already observed that the development and expansion of state aid devices has arisen primarily from the limitation of fiscal adequacy in local revenue sources. This inadequacy is not necessarily an evil, though the means of overcoming it may produce evil results.

At its Twenty-sixth Annual Conference, held in Phoenix in 1933, the National Tax Association received the report of its second committee on a plan for a model system of state and local taxation. Occasion was taken by this committee to comment on aid to lower governmental levels in the following language:

> Money collected by one government and then handed down to another does not get treated with the same care as the recipient exercises in spending money raised by its own taxes collected from its own people.

While these remarks were made with primary regard to Federal subventions to states, the principle is no less applicable in the case of state-local subventions.

State aid ought never to take the form of lump-sum distributions of state revenues to subordinate governmental units for general purposes. This implies that the state should earmark all of its aid and make it available to local units only for some specific purpose. I think this prin-

ciple is sound. It presumes that the state authority is better qualified to prescribe the manner of spending its tax revenues than are local governments. It presumes further that the purposes for which state aid is given will in all instances be susceptible to distribution formulæ that are workable and at the same time equitable.

It is almost trite to remark that governmental functions which under a simpler and less costly administrative technique were adequately financed and directed by local authorities, have in more recent times lost that simplicity and purely local application. The administrative horizons of public welfare, education and highways, for example, have grown beyond the bounds of district, county and municipal lines. And because of this growth there has developed the need for a more comprehensive administrative authority, possessed of fiscal possibilities which do not inhere within the limited tax provinces of political subdivisions. This authority is the state government.

When state aid attains such magnitude as to represent for a particular governmental function the bulk of its monetary requirements, evidence points to the wisdom of considering that function as one which should be centrally administered. Public free education serves as an apt example of what is here intended. The growth of educational costs in this country has been little short of phenomenal during the past quarter of a century. These constitute the heaviest single drain upon local tax sources. Education represents, moreover, a governmental responsibility whose costs in a particular locality bear virtually no relation to wealth or tax-raising ability. The constitutions of most states fix upon the central government the responsibility for providing universal free schooling. This is as it should be. The state, however, cannot justly require local governments to achieve and maintain high standards in public free educa-

tion unless it takes cognizance of the respective abilities of these units to raise funds sufficient. The result of varying local capacities thus forces the central authority to underwrite, as it were, the basic educational minimums in order that the population in all parts of its territorial area may enjoy educational opportunities.

Only a few of the states have undertaken to attack this problem on any scientific basis. A few years ago this problem was the subject of a study referred to the writer by the Governor of Virginia. Analysis of the situation developed the fact that although state appropriations for public free schools had been enlarged at every legislative session, the educational service was failing in large measure to enjoy the benefits of this added money. The reason was that local appropriations were being arbitrarily reduced in almost exact proportion to added state support. The writer proposed what to him seemed to be a fair solution of the problem.

This proposal contemplated the following procedure:

1. Let the educational authorities develop the fiscal needs for an adequate minimum instruction program for the entire state.
2. Require of each locality in Virginia (100 counties and 24 independent cities) that to the support of this program each would contribute a sum equal to ¾ of one mill on each $100 full value of locally taxable property.
3. The state government would then pay to each locality the difference between the total cost as established in the minimum program and the sum to be produced by the ¾-mill tax.
4. The minimum program would not restrict the localities from going beyond the standards set, but if they elected so to do, the cost would be entirely their own to bear.

Such a program would have imposed equal proportional burdens upon different local units, but poor areas with low taxing resources would have enjoyed a larger proportional share of the state-granted funds than the wealthier areas.

I may say that while the proposal then made was not adopted, it seems entirely likely that steps will be taken in the not distant future to adopt the principles, if not the specific formula, of the proposed plan.

For most states, I believe it is neither feasible nor wise to assume complete fiscal responsibility for educational costs, even on a minimum program basis. The plan suggested by the writer did not contemplate this for Virginia. There are certainly some values to be gained by leaving some vestige of local counsel and initiative in our educational system, but the broad social features of education and the responsibility for fiscal control must be of necessity vested in the central government.

The Price of Local Self-Government

Another point which I would make is that the price of local self-government may become greater than the benefits which it confers. When functions which local governments have traditionally served weaken and fail to justify their relatively inefficient management, the heritage of local rule must give way to the broader concept of general public interest. In Virginia such a situation developed in the case of local roads.

Prior to 1932 the state shared with the county governments the gasoline tax revenues, giving them as much as 30 per cent. This refund, which amounted to $3,500,000, supplemented an approximately equal amount raised through ad valorem property taxes by the counties, making a total of about $7,500,000 spent annually by local governments for road construction and maintenance. The governing boards of the counties formulated the road policies and administered local road programs in a manner which sometimes challenged credulity. There were instances in which road money given by the state was not only wastefully spent,

sometimes for the purpose of procuring local political patronage, but occasionally not even spent on the roads. This situation, coupled with the fact that much of the Virginia countryside was in the mud for too many months in the year, brought loud protestations against the burdensome weight of taxes upon Virginia agriculturists. All this clamor culminated in an act of the General Assembly in 1932 which provided for the creation of a system of secondary state roads. Counties were given the opportunity to vote on the question of remaining under the then existing system. Counties not electing to vote on the question were automatically embraced by the provisions of the new law. As a result of this law, only 15 out of Virginia's 100 counties voted on this question in August, 1932, and of these only four decided to continue under the status quo. Since 1932, one of the four counties has elected to come under the new law.

The result of this reform is evident to Virginians who knew the days before 1932. Today local roads are travelable the year round. More than 40,000 miles of local roads are being cared for by the State Highway Department at a cost of from $1,500,000 to $2,000,000 less than previously. Here is an instance where a demand for local tax relief was fully satisfied and a higher quality of governmental service rendered at the same time through centralized control. It seems hardly necessary to say that had the state attempted to give the relief asked merely by increasing the gasoline tax refund in an amount equal to the then locally raised road funds, not only would the situation not have materially improved, but further waste of taxpayers' money would have ensued.

Yet there were in Virginia during the period when this plan was being evolved any number of locally prominent political leaders who fought bitterly against the proposal

on the grounds that it was a movement aimed to destroy local self-government and initiative. These same leaders prophesied that if the plan were adopted it would prove to be a dismal failure.

The plan was put across, it is true, because it carried with it relief for real estate. No less credit is due, however, to those few men representing the broader state interests whose minds conceived this plan and pushed it through to fruition. They exemplify a type of leadership which I venture to say is generally found more prevalent in central than in local governments. There is nothing, after all, inherently sacred or defensible in the preservation of local control when local authority does not go hand in hand with efficiency, and I use the term "efficiency" with the full knowledge that it is frequently much abused.

Approximately three-fourths of the total costs of state and local government in this country goes for the four functions of schools (41 per cent), roads (14 per cent), public welfare (14 per cent), and health (6 per cent), all of which are broader than the special and individual interests of the local units. These functions now dominate the social-political arena in American states and, in all likelihood, they will continue to do so. If this is true, then I believe the state authority must assume the responsible rôle for governmental direction and control in all activities save those in the solution of problems which are wholly peculiar to concentrated urban areas.

The relative differences in the capacities of local areas to support the four major functions just mentioned is of itself sufficient to argue for further centralized control. This does not mean that the state authority must impose and collect all the taxes, though excellent defense might be made of such a proposal.

The point I make here is that the state authority must

take hold of the reins for all governmental functions in which it is called upon to furnish a more than substantial money contribution.

Summary

I conclude this paper with the following observations by way of summary and emphasis:

1. State aid has come to represent an indispensable feature of governmental financing. In one form or another these developments have been inevitable.
2. I am afraid that the principle of state-collected locally shared taxes offers a less satisfactory solution to the problem than other alternatives. From the taxpayers' point of view this device, though it may shift the form of the tax, does not always reduce taxes. The incidence of the composite total of taxes may tend to even greater injustices. Local governmental authorities incline toward recklessness in spending money the onus of whose tax impost lies in some other level of governmental authority.
3. The greatest hope for the maximum utilization of moneys put up by the state to supplement governmental functions formerly maintained in whole or in part by local units lies in the state's assuming greater control of basic governmental programs. The obligation to *pay* must carry with it the right to *prescribe* the things which are to be bought.

PART FOUR

STATE CONTROL OF LOCAL FINANCE

CHAPTER XII

STATE-LOCAL FINANCIAL RELATIONS—DEADLOCK OR CONSTRUCTIVE REFORM?

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THE present is a time appropriate for the re-examination of financial relationships among levels of governments, particularly between states and localities. The past half-dozen years have been significant in the development of Federal relations with municipalities and other bodies. In contrast, the financial relations between states and localities have been devoid, except in certain states, of the marked changes so frequently produced by crises. Exceptions to this all too general conclusion are the reallocation of state-collected revenues and the limitation of taxes locally collected. Here, however, nothing new was introduced. Past trends, including some of the worst of them, merely were continued under depression needs and psychology. Other and less sensational changes, let it be said to the credit of a minority group of states, were introduced by the budget, reporting, and accounting laws of Virginia, Pennsylvania, New Jersey, Kansas, Idaho, Oregon and a few other states.

Visualize the difference in a meeting discussing this subject today and a session devoted to the same subject a decade ago. Then local debt was rising precipitously by large annual increments. Today, the total state and local debt in the United States is substantially the same as half a dozen years ago. If the upward movement of debt was

halted, at least temporarily, by depression restraint and Federal aid for relief and public works, the long demanded reduction in property taxes was attained in the depression period. But how? Aside from state control through tax limits and the self-control of local budgeteers, the depression reductions represented not the action of government officers but the inaction of taxpayers. That is, tax reduction was tantamount to tax delinquency.

The entire fabric of state restrictions of local finance became more or less irrelevant during the depression. Confronted with a crisis, the restrictions, perhaps suited to prosperous periods in some respects, bogged down under the impact of conditions for which they obviously were ill-suited. Such a crumbling occurred, in the view of some, because the restrictions were not sufficiently severe; in the view of others, because they were overly severe. At all events, the reversal of regulatory intent was imperative. For example, the refunding of bonds because of inability to pay, long anathema to orderly financing, was invoked widely to stave off the worst specter of defaults. Borrowing for current purposes was frequent, not only for relief, but for debt service and other normal expenses. Debt restrictions and even limits were lifted to permit localities to participate in the Federal public works program. A large share of the capital financing was not through the regular local units or by the usual forms, but through special districts.

So widespread has been the reversal of inherited restrictions that if Alice were to add a new chapter to Wonderland this chapter could well be formed from what may appear as the upside-down movement of local finance and its relation to the state and Federal Governments. Are we sure that the movement has been entirely upside-down? The phrase "back to normalcy" was given currency over a decade ago. Yet that lurch back was followed by too many

profound changes ever to make possible, let us hope, the return to the normalcy with which Mr. Harding so disagreeably familiarized the country. Will you not agree, therefore, that fiscal relationships invite re-examination to appraise the rôle of state regulation in the fiscal structure? Essentially, we should address ourselves to a series of questions, searching as to our premises and preconceptions and tested by an impartial record of actual operative experience.

Tax Limits Or a Balanced Fiscal Structure?

The one marked change during the depression period of seeking to restrict and reorder local revenues through tax limits and state aid or sharing of taxes calls for not one but several blunt questions. Here the student, the administrator, and the taxpayer lock horns in internecine warfare. That tax limits are a natural, even if mistaken, consequence of the desire for expenditure control should be recognized by those who are most earnest in condemning tax limitation. Tax limitation is gaining not a few respectable and academic advocates on the ground that, however undesirable limits are in themselves, limitation is a club to force the reorganization of the state tax structure upon otherwise unwilling states, the imposition of new revenue sources, and the relief of the local property tax by the redistribution of state funds to local units. Passing aside the obvious admission that limits do not reduce costs but merely reallot revenues, an admission implicit in this viewpoint, the objective of revamping the tax structure is so desirable that this claim forms a challenging question. During the "thirties," liquor or beer taxes were imposed by all states with only a slight reference to the over-all limits of a dozen states. Chain store, cigarette and tobacco, amusement and other taxes were adopted or increased in

consequence with objectives of economic regulation or revenue needs.

The income tax had made a promising beginning in the pre-war and immediate post-war years only to come to a halt in the middle twenties. By doubling the number of states with income taxes, the depression made a welcome contribution to the tax system. But did tax limitation force this result? Rarely in the early or recent years has tax limitation, especially in the dozen states with severe limits, been associated with income taxes now prevailing in some form in 36 states. The tax limit is notable chiefly for promoting the sales tax. The states in which the tax restrictions have been most severe through over-all limits have turned to the sales tax to make up for the revenue lost from property tax reduction. Even here, qualification is necessary. The number of states with sales taxes, 24 in 1937, is twice the number imposing over-all or other drastic limits during the "thirties." The sales tax is as apt to be introduced without drastic limits as with over-all property limitation.

The depression period demonstrates that the seemingly most valid claim for property limits—in forcing an overhauling of the tax structure—is exaggerated and to a large degree false. Is the tax limit claim entirely specious? The valid part of the claim arises from the tardy action of many states in introducing newer or progressive types of taxes, and from the neglect of many states with newer tax sources to work out a balanced tax structure in which income, corporate, motor and other taxes play an appropriate part. The experience of the tax limit in forcing a broadening of the tax base, unnecessary and inconclusive as is limitation for this purpose, is of value in pointing to a broader and inclusive control of all taxes in which each revenue source is related to the functions performed, the public unit

rendering the service, and to the proportionate share that each tax should contribute to the total picture.

Essentially, the question is whether the states can supplant the customary method of reform by "jerks and jumps," characterized by patches to state tax laws and limits of property levies, by a control system invoking the three elements necessary to a balanced fiscal system: (1) the rational apportionment of tax loads and public costs among all revenue sources; (2) the allocation of functions among governmental levels; and (3) the apportionment of revenues for functional support among all governmental levels. Intermittently, one or even all of these elements are recognized by state laws widening the tax base, or by the transfer of functions from the locality to the state, or by state aid or other devices for reallocating state-collected revenue to communities. A state-wide equalization, encompassing these three elements, is dependent upon the introduction of equalizing machinery which regularly "takes stock" of the facts of a given situation and ensures a readjustment of tax loads commensurate with functional needs and tax resources.

Instead of the chance consideration of one or all of the three elements of tax control, the state tax commission could be charged with the regular preparation and submission to each legislature of a compete measure for financial and administrative equalization. This measure would set forth all tax needs and functional loads of state and local governments and would recommend proposed readjustments in the rate schedule of taxes for the year or biennium. Drafted and adopted recurrently, somewhat in the manner of the recurrent adoption of a budget, the equalization control measure would depend, not on a single budget, but on the composite budget requirements of all state and local governments as well as on the tax resources available to

finance the needs. To ascertain fiscal needs and to balance them against revenue sources is a budgeting device which is incomplete, because a budget can refer only to one unit of government and omits total budgetary claims of all governments and their economic resources.[1]

The "Old Bunk" or Expenditure Control?

The levy of new taxes to relieve the property tax has been tried too frequently with illusory results to beat the tom-tom again on that note. To prevent equalized budgeting from becoming the "old bunk," the periodic upheavals in the tax system, in which the patient suffers a high fever and debility, must be replaced by stabilization through continuous readjustment in tax bases, rates, and revenue distributions.

Equalization should not be misconstrued to mean an identity in cost loads, or an imaginary uniform level of costs among hundreds of units, but rather as a device for allocating public costs among public bodies and taxpayers. Allocation of costs can differentiate among expenditures as to (1) costs of essentially state functions to be financed entirely or mainly by state funds, (2) costs of essentially local functions to be financed by local funds, supplemented when necessary by state distributed revenue, and (3) common or joint functions financed jointly by the state and local units through equalization. This course is not startling. The

[1] Equalized budgeting, viewed as stages in a process, would (1) set forth the fiscal requirements of all functions by state and local governments, (2) state the past and future yields of taxes levied by each unit for its own purposes, (3) indicate the revenues requiring reallocation by the state to local governments to make up local deficiencies, (4) test the yield and equity of the taxes by an analysis of their weight upon each type of taxable wealth or income, and (5) readjust the rate schedule of each tax in accordance with an equitable burden upon taxable wealth and income and limit the total tax to an amount required by needs and permitted by tax capacity.

state need merely do systematically what it now does haphazardly.

The state should not redistribute revenues to localities without squarely facing the question of expenditure control. A practical answer is that the state cannot turn over increasing revenues to localities without setting standards for the control of administrative performance in the local use of state money. Conversely, the state should wisely refrain from a detailed control of the expenditure of funds locally raised. The gains from this division of responsibility are decisive. The state safeguards the spending of money instead of acting as Santa Claus. In turn, the community must face the consequences of its own action in spending its own money. The drafting and actual application of standards has far more practical possibility in administering state grants than in any other aspect of state-local relations. Here, then, is the chance for introducing administrative and cost standards without a disguised state absorption of local government. The sheer force of example in the local application of standards for state-used funds will be of genuine value to infiltrate improved methods throughout local administration without straightjacketing communities. Local control of expenditure by communities has as necessary a part to play as the different kind of service by outside agencies.

To debar the "old bunk," the reallocation of state funds to communities must have as a complementary aspect the devising of an equitable set of state and local taxes. Without tax revision, redistribution is a patchwork. The recent compilation by the Tax Policy League of state tax collections for the fiscal year 1937 is a demonstration without argument for state tax revision. Sales and other consumption taxes supplied 27 per cent of the total state revenue, or $731 million out of $2,753 million. By including the

gasoline tax, consumption levies accounted for 52 per cent of all state income. The two taxes based distinctively on ability, the income and the inheritance taxes, furnished $470 million, or 17 per cent. In too many states the newer progressive taxes are featherweight loads, and the consumption taxes and even the state property levies are heavyweight burdens.

This result is not entirely the fault of the states. The concentration of wealth and income in limited areas debars many states from an ample tax base when the Federal Government is imposing taxes upon many of the bases from which the states also collect revenue. Coordination of Federal and state taxes is as imperative from the standpoint of the community as from the state. The abatement of tax conflicts, the coordination of overlapping taxes, and the improved distribution of Federal funds for relief and welfare are sectors of the problem for immediate attack.

Rational Or Irrational Control?

If state control of local expenditure from state aid displeases home rulers, local self-rule in spending funds locally raised is opposed by centralizers. Frequently proposed and at times feebly tried, state control of local tax levies, budgets and borrowings is likely to miscarry and self-defeat control.

The best known state control of the "twenties," the Indiana plan, was superseded by tax limits in which administrative review plays a secondary part. Objectionable as are many features of the Indiana plan, including the incredibly bad 1937 law preventing the issuance of bonds except through a crackpot system of petitioning, the critical would do well to acknowledge merit. This is found where it is least expected, namely, in the application of tax limits. Instead of arbitrary limits applicable uniformly

to dissimilar conditions, the limit is virtually variable or elastic to correspond to the needs of individual cities and counties under the determination of county tax adjustment boards and possible appeal to the State Tax Board. Waiving the validity of this review mechanism, Indiana has accomplished a large measure of property tax reduction through an elastic limit combined with the redistribution of state funds to localities. Other states experimenting with administrative control, as Oklahoma and New Mexico, turned to tax limits to obtain the tax reductions not secured by control plans.

The view of the state agencies too often has been that of cutting taxes "at all costs." If the cost is local inefficiency, as by forcing borrowings in substitution for local pay-as-you-go methods, or if the tax rate is cut by using surpluses or miscellaneous revenues, the advertising of large savings can create an atmosphere of tax reduction. That atmosphere unfortunately breeds antagonisms between the community groups benefited by services and the taxpaying group which is not reconciled by appealing outside the community to the state. The breach between groups often is widened by this course. The narrow conception of state review as purely a device for property tax reduction has prevented the development of review to work out expenditure plans embodying social purposes and community programs. Administrative standards of services and costs, upon which the validity of the state action must rest, cannot be formulated out of a few hours hearing of a local budget petition, no matter how intelligent are the state officials. The standard of the tax rate is pardonable, even if misleading, if used by the man-on-the-street; it is inexcusable because misleading when openly or covertly used by state officials.

Experience of states with various types of administrative

control suggests the selection of specific aspects of the financial process in which the state has an interest and in standardizing them for state control. For example, in local borrowing the questions to be considered include economic capacity to borrow, the business practices of using public credit, and the community planning of public works. State control need not span the entire arc of debt administration. State action is most necessary in establishing limits for capacity to borrow in lieu of reliance upon discredited limits expressed as ratios to assessed valuation. Other aspects of borrowing, although subject necessarily to state procedural regulation, may be left to state advice and local determination.

Consider the two states with the best advertised plans, Indiana and North Carolina. The 1937 Indiana laws prohibit the state from interfering with the details of local budgets. State action is confined to total amounts of budget classes. Contrary to the propaganda but in accordance with need is the Indiana authorization for budgetary increases as well as decreases. North Carolina's control of local borrowing is absolute in law, but in practice the state so far has been concerned with defaults, refunding and temporary loans. Absolute control is theoretical, not practical. North Carolina has sought standards in the enabling acts specifying several tests in passing upon bond issues: and a constitutional amendment provides for popular bond referenda and other debt restrictions. Without better standards, control in any state is apt to result in rubber-stamping local applications—the superficial review that adds nothing but the imprint of a state clerk—and the "politicating" of sub-rosa meetings leaving no trace but the bad aroma of political cigars.

Where the state is succeeding, in contrast to abortive schemes, is in the dual method: first, of selecting special

subjects or processes for state administrative control; and, second, undertaking in an advisory capacity to assist localities, especially the smaller units, in working out their problems. Select processes for which control is suitable may consist of tax levies or budget appropriations outside of or in addition to the regularly locally adopted ones; emergency loans or levies; the issuance of funding or refunding bonds because of local failure or inability to pay debt; temporary receiverships during the period of default and its cure; certification of the amounts required for debt service; the legality of local adherence or departure from state-prescribed regulations; and the honesty as well as the legality of contracts.

State administrative review, accordingly, has for its first objective the aim of making local budgeting and borrowing work out successfully instead of state assumption of the entire job itself. By initially prescribing modernized budget, debt and fiscal procedures, a significant question which the lack of time forbids me to discuss, the state will establish the framework through which local financing will function. The question then becomes one of local compliance with or violations of the prescribed procedures, a subject fit for state control rather than the detailed minutiæ of local administration action.

Since so many of the grave financial problems arise from the existence of overlapping units, preventing a total community view of operations, a composite view of community operations is imperative through either state action or regional units, preferably regional planning commissions. A division of duties suggests that to the state would be assigned the function of periodic revision and control of total revenues and expenditures, in accordance with social needs and economic capacity. Upon the regional planning commissions, representative of local communities, would

devolve the more detailed examination of immediate budgetary and debt administration fashioned by the requirements of each of the overlapping units in different community areas. A strategic opportunity for integrated administration is for the state to work with the small corps of trained staffs attached to regional bodies. We can not fold our hands and wait idly for the improbable consolidation of numerous units to rationalize local areas. Time must be taken by the forelock by organizing regional units intermediate between the locality and the state or the state and the nation.

At times an approach to a problem is more important than details that vary among states. The approach is the rejection of absolute state control that is neither practical nor desirable, and the substitution of administrative control as relative to the differing requirements of different kinds of local units and the differing requirements for control or advice for different subjects or processes. Restated, state-local relations demand classification according to the types of units supervised and subject matter controlled. The degree of supervision cannot be the same for all units, large and small, wealthy and poor, or corrupt and efficient. The kind of supervision must vary from the purely routine matter to the exceptional abuse requiring drastic intervention. Dealing with these patent differences is possible, of course, in administrative instead of statutory supervision. The indifferent results of too many supervisory schemes flow from the indifferent recognition of the very virtue of the administrative form of supervision that permits variability instead of uniformity. When the relative differences among localities and processes are recognized so that good government carries its reward of larger freedom, and bad government its own penalty of restricted freedom,

the state will be on the road toward more durable local reform.

Basic or Superficial Supervision?

The question becomes, accordingly: What can be done if complete state control of local expenditure as to budget purposes and amounts, tax levies and borrowings is practically impossible and civically undesirable? The states face the paradoxical situation, on the one hand, of lacking state control of local expenditure and, on the other hand, of seeking to evolve instruments of control without assuming direct or complete control. Basically, the problem arises from this paradox. To carry forward the previous suggestions as to what may be done to resolve the dilemma, the state has available the prescription of budgetary procedures and allied regulations of accounts, audits, reports, and borrowings. Approximately two-thirds of the states have enacted local budget laws of varying scope and vigor. The need is not merely to extend budget laws to other states but to re-examine the fiscal regulations in all states to ascertain the patent deficiencies and more thoroughly to utilize the potential values of fiscal regulations for expenditure control.

The chief deficiencies in the past and the chief possibilities in the future flow from the use or misuse of the budget, which too often has rested upon faulty or no state-specified procedures, and consequently upon faulty or no local administration. Orderly budget and allied processes, outlined by state mandate, make possible a local expenditure control that the state can assist. The budget procedures afford the central instrument by which to integrate the various fiscal processes into a single unified system that makes feasible expenditure control. Personnel and salaries, the functional performance of services, supplies and materials, debt serv-

ice, capital improvements, and overhead costs are phrases bandied about and casually or perfunctorily recognized in budget regulations and documents. By making the budget expressive of them in documentary form, and by making regulations controlling them through the allied techniques of accounting, auditing, reporting, and borrowing, the budget becomes the central axis around which fiscal administration will pivot.

Do the state budget and other fiscal regulations answer this description? Rarely, yet past progress contains the promise for improvement. Of necessity, the state as well as the localities were first concerned with setting up a system that at least looked like a budget system. Of necessity, the first requirement has been merely to have a budget in which total estimated expenditures were balanced by estimated revenues, thus avoiding current deficits and floating debt. This view has the iron compulsion of avoiding chaotic financing. New Jersey, for example, is in the throes of transition to so-called cash budgets because over-optimistic revenue estimates have been balanced against pessimistic expenditure estimates. To stop at this point, however, will be to miss the more significant values of budgeting and make impossible expenditure control resting upon an integrated fiscal administration. The usual budget law is immensely concerned with the accounting mechanics of setting up a budget and with regulations, not objectionable in themselves, regarding deficits, contingent expenses, deferred charges and other items.

Some state systems go beyond this necessary but elementary stage by specific regulation of debt service as part of the budget. Herein lies the clue to improvement. As debt service is coming to be recognized for regulation, so the other aspects of expenditure, personnel and compensation, materials and supplies, and capital improvements invite

regulation not identical to that of debt service but appropriate to each subject, each phase of expenditure. Faced then with the paradox of seeking to assure expenditure control without itself completely controlling, the state first may work toward the goal by integrating fiscal processes through the central instrument of budget control only to face a second paradox. Following integration of fiscal procedures and regulations, the total range of expenditure, whether from taxes or borrowings, must be resolved into its component parts, the individual types of expenditure. What can not be conquered as a whole, except through irrational measures, may be dealt with rationally in parts by individual measures.

The first and most important class of current expenditure, of course, is for personnel, the costs resulting from obsolete and strange statutory regulations of salaries and wages, mandatory outlays for positions "covered in" by tenure protection, or the total indifference to the equitable setting of fair pay rates. The repeal of a substantial share of these statutes, resulting in predetermined claims upon local funds regardless of equity, would be welcomed by all, except those with vested interests in the perpetuation of over-privileged or under-privileged classes within government.

Aside from repeal, can personnel be tackled as a fiscal problem? It has not been so tackled. Indeed, the entire problem of personnel has been handled imperfectly by the state in its local relations. State agencies supervising local finance have had neither statutory authorization nor facilities to deal with personnel or its costs. Nearly three-fourths of the states lack civil service systems. Only seven state civil service agencies supervise local personnel, the control usually comprising part of the local employees. The wide extension of the merit system in local employment,

desirable as is this objective, is improbable through state civil service agencies.

Personnel has so pronounced a financial aspect that not a few cities merge finance and personnel in a common control agency. A similar merger in state supervisory agencies is not impossible in the states lacking civil service commissions, through the development of personnel instruments by finance agencies. The two main personnel tools, classification and standardization of work and pay, are essentially financial tools that dovetail into modernized budgeting and auditing. If expenditure control is tackled through personnel costs, and this approach is one of the more fruitful ones, the finance supervisory agencies will fail unless they tie-in these personnel tools to the more customary but limited finance methods.

This approach is not all. While the preponderant number of states lack personnel supervisory agencies, most of the states regulate local personnel through functional departments, education, highways, health and welfare. The most notable example, of course, is the setting of minimum standards for teaching positions or certifying to the eligibility of teachers by state school departments. Similar techniques, including the drafting of job specifications, have spread to other departments with reference especially to county rather than to municipal employees. Functional supervision is never likely to cover completely the local field; but, if coordinated with financial supervision, instruments for control of personnel costs will be available even without the spread of state civil service commissions.

Having been too exclusively concerned with personnel and other relations between states and localities in terms of control, thereby self-defeating personnel improvement, a newer approach is being substituted in terms of the training of officers and professional standards. After all, we

are talking not so much concerning legal entities, the various public bodies, as about the men on the job—the officials who are or may be members of professions. Engaged in common tasks, speaking the same language, the members of a profession that recognize self-imposed standards are more likely to bridge the gap between legal abstractions and get a practical job done than will be accomplished through legal legerdemain. The movement for the training of officials under their own organized auspices or in cooperation with state agencies has already more than justified itself, even though only a beginning has been made in many states. Under the stimulus of Federal aid for vocational education, specifically granted for this purpose by congressional act in 1936, the responsible state educational officers will have funds available for the wide extension of training in cooperation with public officers associations.

Officers associations are acquiring a significance for cooperative municipal action broader than training, important as are these programs. For example, ten leagues of municipalties are acting as purchasing agencies in the quantity buying of supplies and materials, the second main class of expenditure. Over a hundred municipalities use the service of their own organization, the Michigan Municipal League, in purchasing materials. A field for voluntary associational action is emerging in which local officers cooperate with state departments in technical procedures, fiscal regulations, and legislative measures. The future development of associational action depends no less upon the professional capacity of both the state agencies and the associations than it does upon the ability of both to work together for the public good.

Central purchase of local supplies has been nibbled through state action, but no real bite has been taken. A half-dozen states offer their state purchasing departments

as agencies to cities and counties in buying materials. The enabling laws are virtually dead letters. Undaunted Pennsylvania in 1937 authorized her new purchasing department to furnish price data to localities and to negotiate contracts with vendors selling to the state so that cities can buy materials at the same prices paid by the state. State buying may advance for special types of units as institutional agencies, or for specific functions like highways.

A different approach may yield fruitful results. This involves the establishment of a local purchasing procedure and recurrent state examinations to determine whether the localities have adhered to the procedure or have stifled competition by collusion in bidding and other means. Essentially, the standardization of buying specifications is required in order to assure local buying of goods of proven worth and upon a basis permitting genuine competition. The National Bureau of Standards by the scientific drafting of commodity specifications has given more of a stimulus to standardization than any other agency. In the evolving Federal relations to state and local governments, one aspect obscured by more sensational events is the past and possible research for drafting standards serviceable alike to the nation, state and community in various services.

Substantial Or Meager Economies?

The class of expenditure represented in the first instance by capital outlays and in the second instance by debt service is at once the category most difficult to control, most subject to limitation and detailed regulations, the least advanced in actual application, and the class most susceptible of constructive reform. Further debt limits may be imposed and better worked-out limits are desirable; but if future debt control follows the past channels, future progress will be dismal. In brief, bold measures are neces-

sary if substantial economies in sight are to materialize instead of remaining paper possibilities. The theory of one of these possibilities, public works planning and capital budgeting, has been familiarized in recent years. Under the leadership of the National Resources Committee, state planning boards are building the framework of local, regional and state planning through planning commissions and techniques like public works inventories.

Independently of state control of local budgets and borrowings has evolved the review of local public works by state functional departments. School building plans are reviewed by state education departments in two-thirds of the states; local highway plans, usually county plans, are reviewed or road specifications are furnished by half the states; nearly all the state health departments examine and certify local plans for water works, sewer systems, and other projects affecting sanitation; and a growing minority of states review the plans for penal and welfare institutions of cities and counties. The review system has possibilities that may be realized. State inspection of the local public works during and after construction characterizes many of the review systems in vogue, although inspection too frequently is omitted. The device of certifying the construction as to compliance with standards is invoked to a less extent. Too frequently financial conditions and needs are neglected or subordinated to functional aims. These deficiencies are not fatal, for public works review is growing vitally and can enhance the values already demonstrated.

The states can and must do more. The objective of a planned capital budget has been difficult if not impossible of realization, because budgeting has been occupied with current operations based upon the period of a single year. Improvement budgeting requires transfer from the arena of discussion to the field of regular administration by a

restatement of state acts governing local budgets and by a readjustment of local procedures. Not a few states require the inclusion of bond receipts and improvement costs in their budgets, the many omissions attesting to the overemphasis on current operations. With an all-inclusive budget as the first step, additional measures call for the drafting of long-term capital programs by regular local planning agencies; the review and ratification of the program by the local governing body for incorporation into the official budget; the formal adoption of a period of years, as five or six years, during which the scheduled estimates are legally binding, subject to legally adopted revisions each year; the authorization either of recurrent appropriations or special tax levies for the duration of the period to guarantee the availability of funds for the programmed outlays; and the withholding of local borrowing power until the capital budget has been locally drafted under state advice, especially as to the division of costs between borrowings and tax revenues.

In the division of costs between borrowings and tax revenues is the key to reduce the aggregate borrowings and to approach a pay-as-you-go plan, an objective that can be approached although never fully realized. Local units acting individually can even off the peaks of excessive borrowings during prosperous years into the valleys of needed borrowing during depression years by planned programs, specified by state-prescribed procedures. Acting individually, however, community needs often vary so among years, and tax resources often are so restricted, that borrowing is normal and payment from tax revenues is unusual. To reverse the process so that payment from tax resources is usual, especially during prosperous years, and borrowing is unusal, except during a depression, cooperative local and state action is imperative.

Not merely state credit but local contributions to the funds would build up the assets of the state-wide funds used either on a revolving basis or as a reservoir from which to draw credited deposits. The attack on debt costs then becomes specific and drastic. These costs, of course, consist of two variables, interest and debt retirement. Interest may be set at rates determined not so much by fluctuating markets as by social needs. In many cases, no loan and no interest whatsoever would be necessary; for the assets of the funds and the annual turnover in volume of transactions would be based upon the total annually recurring capital transactions of the state and all its local units in contrast to the widely variable capital needs of individual units under the prevailing system.

Doubtless the proposal smacks of utopianism. Pay-as-you-go, however, is even more utopian without a mechanism for its accomplishment. Conversely, the use of public works as a business stimulant during a depression must always operate imperfectly without the prior mobilization of funds and plans. The English Local Loan Fund is suggestive. While the stock of the Fund is held partly by the public and partly by governmental bodies, the National Debt Commissioners control the investment of all funds. During recent years, the total principal outstanding has been approximately $1,400 million, the interest rate recently being 3 per cent. By regulating the amount, timing, and type of local borrowing from the Fund, the English method provides a "governor" for the credit market and the local use of credit that is helpful especially to small municipalities.

Massachusetts has administered two loan funds during the depression, a welfare relief fund and a tax title loan fund. Especially significant is the latter fund in temporarily financing municipalities embarrassed by depression caused tax delinquency. Instead of permitting defaults

or other disorders, Massachusetts loaned over $25 million in 1933 through 1935 at interest first set at 4 per cent and later reduced to 1 per cent. As delinquencies were paid and tax titles redeemed, the cities and towns repaid the loans, $18 million having been repaid by 1936. The Massachusetts experience is suggestive to states chronically embarrassed in current borrowing operations. Not impossibly, public credit of today operates on too wide a scale for the states alone to do more than follow the modest but successful precedent of Massachusetts. Not impossibly, national action through Federal public works funds, or the Federal Reserve system, is necessary to complement state action.

In conclusion, whether we like it or not, the interest of many has been centered on tax and debt limits as restrictions for self-protection. The ways and means here advanced, seemingly unrelated to these central restrictions, are in fact devices for accommodating limitation to a modern and welfare society. Modern society is producing discords among groups, especially producers and consumers, in a fight for the capture of governmental machinery and the control of public power. The public consumption of governmental services may run counter to producers directly paying for public costs or to consumers indirectly paying for services. The form of state-local relations, accordingly, must not permit the ready capture of public control by minority groups, either producers or consumers, under the guise of slogans. The relationships must be set to bridge the gap among groups in a common good, free the state agencies from the pressure of political groups taking advantage of obsolete forms or poorly devised reforms, and stress the underlying interests of all in public service.

CHAPTER XIII

STATE RESTRICTIONS ON LOCAL FINANCING POWERS

HOWARD P. JONES

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DURING the depression, when taxpayers thronged to city halls and county courthouses demanding that budgets be cut to the bone, we learned that it is a good thing to have a full budget instead of half a budget to cut. The responsiveness of democratic government to the public will is stymied when a large part of the budget is so frozen that it is not subject to alteration at public demand.

For example, in New York State in 1936, according to figures released by the New York Conference of Mayors, nearly half of the total expenditures of cities and villages went to meet the cost of debt service: paying, that is, for something that had already been received. Unless municipalities were to fail to meet their obligations, nearly half the average municipal budget couldn't be touched. In the same year, more than one-third of the money spent by all the cities in New York State for operating expenditures was used to pay public welfare costs, including emergency relief expenditures. It should be realized, of course, that we cannot add the two percentages together, since welfare comprises approximately 16 per cent of the total cost of government although 34 per cent of the current operations. Even so, roughly two-thirds of the cost of city government is embodied in two single items—debt service

and relief—both, from the standpoint of budgetary control, being irreducible items.

The point we are concerned with here is the helplessness of the citizen in this situation. He can do nothing. He cannot control debt after debt has been incurred—it must be paid whether he likes it or not. Relief is somewhat similar. Both costs, moreover, are alike in that their control depends upon solution of a problem long before the lack of solution has translated itself into huge current budget items.

In brief, the situation has gotten out of hand—and at a time when it is most important from the standpoint of democracy, that is, to the democratic unit, the citizen, to keep it in hand. This is not an argument for reduction of governmental expenditures during depression. During the past few years, I have tilted my lance too often at destructive as opposed to constructive economy to be charged with that. Few there are who do not now recognize the necessity for government as a whole increasing rather than decreasing its expenditures during a period of depression.

But we are talking about keeping government under control here, and I submit that when two-thirds of a municipal budget cannot be touched by the man who pays the bill, that municipality has gone out of control.

There are two other among the many aspects to this problem that should be touched on briefly. First, we all recognize that the local governmental job has become too big for the pocketbook of local government. State aid has been rendered necessary. And state aid, which started out as an attractive youngster not to be taken too seriously, has grown up. There is little need here to amplify the discussions of yesterday on this point. But it might be well to remind ourselves that in New York State alone, state subventions to local governmental units reached the huge total of

$194,000,000 during 1937, and I am not including in this figure the total of $67,500,000 of local revenue received from state-administered, locally shared taxes.[1] If this be added, and it might well be for the purposes of this particular discussion, we find that approximately $260,000,000 was returned from the state government of New York to the local units to help them in their job. This runs close to three-quarters of a million dollars a day.

This is not only a lot of money—it is too much money to be spent without any control over the spending. And here again we must look at the unit in our democracy—the citizen. He takes seriously enough the amount that he pays directly to his local government through real estate taxes. But the state is a big unit, the capitol is far away, and by the time his money goes up to Albany and comes back, it looks like a Christmas present.

At the present stage of public understanding of the tax problem, it is just too much to expect the citizen of a municipality to concern himself very much with the manner in which money received from the state government or the Federal Government is spent.

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[1] State Subventions to Local Divisions (in Thousands of Dollars)

	Town Highways	County Roads	Total Highway	School	Library	Physically Handicapped Children	Health	Old Age Security	Emergency Relief	Reforestation	Total
1936	2,995	2,274	5,269	119,225	60	355	679	7,135	39,956	*	172,619
1937	3,065	2,486	5,551	120,874	62	284	722	7,042	59,733	*	194,206

Local Revenue from State-Administered, Locally Shared Taxes (in Thousands of Dollars)

	Motor-Vehicle License	Business Corp. Income	Personal Income	Real Estate License	Billiard License	Financial Institutions	Motor Fuel	Beverage	Total
1936	10,964	8,576	11,573	*	*	3,363	7,544	17,944	59,964
1937	11,363	8,081	16,217	*	*	3,258	8,146	20,416	67,481

* Data unavailable.

The other aspect of this question of interest here is the depression experience with respect to defaults on municipal obligations. Counting all types of local government units, the depression recorded somewhere between four and five thousand defaults on interest or principal or both. If we analyze those situations in terms of debt burden upon property, we find, generalizing roughly, that there were no defaults in areas where the overlapping debt reached less than 10 per cent of the value of the property, that from 10 to 20 per cent represented a danger zone within which there were many defaults. Where the overlapping debt on property reached more than 20 per cent of the value of the property, there invariably was one or more default in the area. We put up fences to prevent people from going over Niagara Falls; it would seem logical to do the same for governments.

Controls on Local Government Finance

As Dr. Kilpatrick has already indicated, existing controls on local government finance divide themselves roughly into three groups—debt limitations, tax limitations, and specifications as to financial procedure and practices. Debt limitation is an essential—it is important not only from the standpoint of control but of actual money saving in interest rates, for the buyer of municipal bonds naturally values highly the bond of a government which is not permitted to over-borrow.

The chief difficulty with debt limitation laws in the past is that they have not limited. There have been so many ways of getting around them. Since they invariably limited the debt of a specific class of municipality, all the legislature had to do was to pass a law establishing another type of local government unit with another debt limit. For legislatures are seldom if ever prohibited from creating

other governmental units for special limited purposes, and providing in each instance for their administration, financing and functions. This has resulted in a tremendous multiplication of governmental units. As far back as 1929, F. H. Guild, writing in the *National Municipal Review*, reported such units existing under at least "89 names and 47 distinctive species, counting the school district once only."

In New York State alone, the number of special districts had reached 2,450 when in the middle of the depression a moratorium on the creation of new districts was declared and no new district could be set up without the consent of the state comptroller. This, of course, has been only one of many ways by which the debt limit has been violated, although from the standpoint of control, it has been perhaps the most dangerous way. It is easy to see what may happen if ten governmental units overlap, each having a debt limit of 10 per cent of the value of the property. Even more serious than this in some states is the peculiar situation under which a larger area than the jurisdiction issuing the bonds becomes responsible for the obligation. Thus, in New York State, the debt limit of the town is all that governs the special district, and there are many instances in which a given area within a town has borrowed many times the value of the property concerned in installing improvements. Needless to add, the improvement has not always created the value which it would have to create to justify the expenditure.

Perhaps the second most popular way of avoiding debt limits has been through exemption of certain classes of debt on one theory or another, usually because they are self-liquidating enterprises. This may be justifiable, but it is difficult to draft a definition of self-liquidating enterprise

that does not require a special administrative agency to apply it!

So far as tax limitations are concerned, I am wholly opposed to the over-all type of tax limitation which has made its appearance in recent years. And I believe that while, in particular instances, tax limitation provisions on particular types of units have had a salutary effect, generally such laws are nowhere nearly so effective as is generally believed. The emphasis in a democracy, it seems to me, should be in the direction of establishing controls for the citizen to operate, rather than freezing into fundamental law the conception of one group or one generation. It is the difference between developing an automobile responsive to the driver under all conditions on the assumption that the driver is capable and intelligent, and putting a governor on the car which prevents him from ever going over thirty miles an hour no matter how great the need for speed.

Under such an approach to the problem, it seems wholly logical for us to require by state law all units of local government to have adequate accounting, reporting, and budgeting procedures, equitable and scientific assessment of property and efficient tax collection methods; it seems wholly logical for us to make mandatory the adoption of the merit system and to insist upon receiving the operating economies inevitably resulting from the establishment of centralized purchasing. What we are aiming at, I think, is the requirement that the bad municipality do what the good municipality would do anyhow, if we may use those terms.

That necessarily involves the establishment of state standards and state specifications, and the establishment of such standards and specifications brings us at once into conflict with the popular conception of municipal home

rule. I yield to no one in my belief in home rule—the municipalities of our country have been individual laboratories of experimentation with democratic processes as a result of home rule and have contributed tremendously to governmental advance. But I think that the municipality must justify its right to home rule. We interfere with the life of the average citizen as little as possible but we insist that the outlaw conform—or else. Why not apply the same principle to units of local self-government?

Possibilities for the Future

As a matter of fact, whether we like it or not, the state is necessarily going to take a larger part in the processes of local government. To keep out the state, we should have to reverse completely all the social, economic and political trends of recent years. We should have to stop Federal aid and state aid. We should have to let local government paddle its own canoe—and we know that is impossible; that it would merely result in the gradual amputation of the functions of local government and their transfer to the state or some larger regional unit. The important thing is to preserve as much home rule as it is possible to preserve while we are insisting that money be not wasted and that local governmental expenditures be kept within reasonable bounds. Up to a point, I would let the municipality determine those bounds, first making sure that adequate machinery to make the processes of local government visible and to enable the citizen to exercise control, does exist. Beyond that point I would let the state step in.

All this is very easy to say and not so easy to do. However, the New York State Commission on Revision of the Tax Laws, of which the presiding officer [2] of this meeting is chairman, and the speaker, research director, has been

[2] Seabury C. Mastick, former New York State Senator.

studying this problem for some time, and we have some suggestions which may be worth consideration.

They are based on the idea that much of the difficulty in connection with the local tax burden is caused by debt, and that in any event control of debt is the first fundamental in any comprehensive expenditure control program. The tentative program of the Commission provides for the establishment of a state agency to be known as the "municipal finance commission," which would have the power to approve or disapprove proposed bond issues of heavily indebted municipalities. The commission would consist of five members, of whom three would be appointed by the governor with the advice and consent of the senate. The state comptroller and the commissioner of taxation and finance would be ex-officio members.

This municipal finance commission would have to approve the issue of any bonds by any unit of local government (except refunding bonds and any issue of less than $5,000), if the proposed issue:

(a) would, when added to the over-all debt of the unit, exceed 12 per cent of the full valuation of all taxable property in the unit, or

(b) would, when added to the direct debt of the unit, exceed in amount the following percentages of all taxable property in the unit: in the case of a county, 4 per cent; in the case of a city, 8 per cent; village, 2 per cent; school district, 4 per cent; any other municipal corporation, 3 per cent.

If the over-all debt of a unit exceeded 20 per cent, the commission would have no option under ordinary circumstances but to reject the application for an issue of bonds.

Under this plan the proposed state commission would have nothing to do with the financial program of a municipality the debt of which was within reasonable bounds. When the danger line—12 per cent—is reached, however,

the commission goes into action. If conditions in the community warrant the issuance of additional debt, this could be authorized; if not, the issue could be rejected. At least an opportunity would be assured for an impartial agency to pass upon any bond issue in any area where the debt has reached a fairly high point. If the debt of an area has reached the 20 per cent boiling point, however, even the commission would have no power except in an emergency to authorize an additional issue of bonds.

The suggestion has also been made that this commission have the power to examine and reduce local budgets on petition of 10 per cent of the registered voters of a municipality or petition signed by owners of 10 per cent of the property as valued on the assessment rolls. There are a good many arguments in favor of permitting such an appeal, but also rather obvious ones against it. In so far as it is possible to do so, we should leave authority and responsibility in the localities. Vigorous conditions as regards local practices can be attached to a program of state aid which would assure the local taxpayers an opportunity to exercise control over local budgets. State aid should no longer be viewed as a *stimulant* to local expenditure but as a *substitute* for local funds. It is in this direction, through a program which provides flexibility and the opportunity for local initiative, that the road to satisfactory standards of local financial administration seems to lie.

CHAPTER XIV

REORGANIZATION OF GOVERNMENTAL UNITS

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THIS paper will deal more with a discussion of need and accomplishment than with methodology. The subject must be broad because it is concerned, according to the most authoritative estimates, with no less than 175,000 governmental units, each with its own taxing power. It takes a broad-gauged imagination to conceive of such a situation.

There has always been a lot of shrugging of shoulders in this country, and the attitude, "Well, we have democracy. It's natural for democracy to be inefficient and wasteful, but it's the kind of government we want. And we have the richest country in the world and we can afford it."

But we are gradually outgrowing the idea that democracy is inherently inefficient and bungling. We no longer are willing to admit that this is the so-called "American way" of doing things. Just what is the "American way"? A way that is marked by inefficiency, bad management, irresponsibility? Hardly. Americans have set the pace for the world in reorganization and sound management of business—and government in this country has come to be mighty big business. There is ample proof on every hand that, Hitler and Stalin and Mussolini to the contrary notwithstanding, the difficulties of American democracy are largely mechanistic and are capable of solution by mechanistic corrections.

For just a single example, the national government and most of the states have prevented the continued waste of many millions of dollars by the very simple and logical means of following other big businesses into orderly plans of centralized purchasing. Still, most of the cities, counties and other units of government are not yet aware, apparently, of this very simple logical method. And centralized purchasing is only one of numerous well-tried and thoroughly proved methods of reorganization for the general well-being, readily applicable to practically every unit of government.

In order to make this or any of the other mechanistic corrections, however, it is clearly necessary that the people adopt a more realistic view and gain a clearer understanding of what needs correction; or, at least, they must become sufficiently restive under present conditions to demand change, as, on a national scale, they have shown themselves capable of doing.

Strangely enough, people are much more aware of Federal and state government than of the smaller units which are closer to them. When we think of taxes in the billions of dollars and when we protest against high taxes and wasteful operations, it is customary to think in terms of Washington, although anyone knows how awkward it is to administer a spanking with one hand while holding out the other for help from the recipient of the spanking.

The plain truth is this: If we really want to accomplish something in the way of governmental reorganization, we should look in our own front yards. Of the 12 billion-dollar tax bill, less than half—about 5 billion dollars—goes to Washington; only 2½ billion dollars to the states; but a very considerable part of it—4½ billions—goes to the small local units of government—counties, cities, townships, school districts, health districts, sanitary districts, pavement

districts, mosquito abatement districts—we could go on like this indefinitely—after all, remember there are 175,000 of them—175,000 separate taxing units, within each other, overlapping one another, bumping into each other in the scramble to serve the patient, long-suffering people.

When Colonel Sherrill gave up a $50,000 business position recently to return to the $25,000 city manager job at Cincinnati which he had held some years ago, he said: "It is my feeling that good government at Washington and in the states depends more on the spread of good government in the municipalities than on any other one factor."

Accomplishments of City Reorganization

The advantages of governmental reorganization have been made so obvious that anyone in any part of the country must be blind indeed not to be aware of them. When the city manager plan emerged as an experiment about a quarter of a century ago, it was only a "novel" ideal of reformers. Since then many cities have proved its practical soundness by obtaining greater services, often at a saving of from 10 to 30 per cent in tax money. The experience of these cities shows beyond a shadow of doubt that there is a tremendous amount of waste under the old systems which we inherited from periods when conditions were totally different from those we find today.

When Cincinnati can progress in the space of just a few years from the worst governed city in the United States to the best, when good management can save a highly-industrialized city like Kenosha from collapse although its great factories suspend activities and tax revenues all but disappear, when Kalamazoo can emerge from the depression debt-free and with a smoothly-working pay-as-you-go plan, there must be sound logic in the idea of reorganizing local government and having a trained administrator at the top.

It was only 25 years ago that the city manager plan was an experiment. While the manager plan in approved form is operating in something less than 500 cities, the effect of the National Municipal League's "Model City Charter," of which the manager plan is a feature, has been felt in countless other cities. For there *are* well-managed cities which don't have the manager plan, of course. Mayors like LaGuardia of New York and Hoan of Milwaukee in some ways conduct themselves more like trained city managers than some of the managers themselves do. But the fact remains that a well-managed city under the mayor plan is the exception, just as is the poorly-managed city under the manager plan.

It is encouraging to contemplate that right under our very noses what amount to municipal miracles are being worked. The success stories of manager cities read like novels. Teaneck, N. J., where the tax rate was cut 10 per cent in the first two months of manager government, every service tuned up and improved, and more service at less cost rendered each year the plan has been in effect; Henrico County, Va., where many long-needed services were provided, at a somewhat larger cost, true, but with such economical management that the tax rate actually went down in three of the four tax districts; Toledo, Ohio, where taxes and the bonded debt were reduced, the merit system assured public employees (for the first time) of permanent jobs, services were vastly improved, all in the face of repeated attempts by the politicians to sabotage the plan—these are only a few illustrations from current experience of what is happening. Perhaps most important of all, however, is the renewal of faith in democratic government in these communities—the revival of a civic spirit that has too long been generally missing from the American scene.

With nearly 500 cities and counties showing the way to

good management, what may we expect of the next 25 years? It is not at all unreasonable to expect that, as the evidence accumulates, the demand for good government will grow to the point where the manager plan of government will be the standard form for cities and counties and, for practical purposes, for other units of government as well.

After all, it is simply another way of saying that we want an efficient form of government coupled with "career service"—of saying that we expect to have trained, experienced people working for us in our government offices, just as we have demanded such abilities in our businesses, our industries, our financial institutions, and in our schools.

Comparatively speaking, the national government is not especially faulty from the standpoint of organization. Many states, also, have made and are making real efforts toward reorganization. Because the counties and the smaller units within them offer the most fertile field for accomplishment through reorganization, being so far practically immune, it is to these quaint relics of the horse-and-buggy days that thoughtful students of government are now more than ever turning their attention.

There is nothing particularly new in saying the counties present the most serious problem and are in the greatest need of reorganization. We have worried about the counties for more than forty years, and for fifteen years or more enlightened leadership has been actively attempting to bring about some semblance of order. We know why we have the county—it was brought over from England by men like Calvert, Penn and the Duke of York, who were given various domains in the early colonial days. They installed the system here because it was the only one with which they were familiar. We keep it in pretty much its original form because we have grown accustomed to it. It is rather difficult to find any other valid reason.

Population centers have expanded according to geographic and economic needs, regardless of county boundaries, producing large cities whose limits overflow county lines. And the people are taxed to maintain two and sometimes even three and four governments serving identical territories in pretty much the same ways. State functions are superimposed upon identical but feebler ones which the counties are compelled to maintain, while towns within the county duplicate these functions for themselves.

Complexity of County Problem

Only a comparatively small minority of the 3,069 counties are financially able or sufficiently populous to provide for themselves in a thoroughgoing manner those services which nowadays have come to be looked upon as essential. Even less logical units are a large majority of the 20,262 towns, the 127,108 school districts, and the many thousands of health and other districts. When it is considered that the *average* population in units of local government ranges from about 3,000 in New England to only about 225 in the West North Central States, this becomes clearly apparent. A large share of the counties and other units can barely raise enough money from taxes to pay their conventional officials, let alone enough to render services their populations expect. In other words, they no longer have any logical reason to exist in their present form.

The legislatures of a few states have recognized the necessity for county reorganization and have passed enabling acts to make it possible for the counties to set up modern systems which will help them cope with modern situations. But nothing happens. That is, practically nothing; for today there are only 7 counties of the 3,069 in this country which have either managers or county executives. The rest of them are in approximately the posi-

tion a large factory would be in if it threw out the general manager and had every department superintendent report directly to the board of directors. And more than a few of these "department superintendents" in counties feel that they should report only to the stockholders themselves. The counties might be likened to little states functioning without governors. Management, long recognized as the most essential cog in the business machine, is still a "suspected foreigner" in the counties.

The counties range in population from 80 (Armstrong, S. D.) to approximately 4,000,000 (Cook County, Ill.), in area from 25 square miles (Arlington, Va.) to more than 20,000 square miles (San Bernardino, Calif.). The average county population is something less than 40,000, but four-fifths of all the counties have less than that average population. These figures are less significant than would be the figures showing the assessed valuations and the available tax revenues. Obviously, a very large proportion of these counties are not financially able to supply basic services on an efficient, effective basis.

For many years consolidation of counties into larger, more workable units has been urged. But even the hardships of the depression, which forced too many counties to default on at least some of their bonds, reduced the number of counties from 3,072 to 3,069. That is all! It would seem obvious, even to the politicians who like the counties as they are, that paved highways, railroads and the general ease of communication make our multitude of counties ridiculous. The legislatures of some states have passed enabling acts to permit counties to combine and remedy this very serious situation. But, again, nothing much happens. Typically, any suggestion of consolidation brings a reaction like this: "What, combine dear old Kosciusko County with La Fayette and Steuben Counties?

What would you name it? Where would you put the county-seat? Who would get the courthouse? Do you expect us to give up all the fine traditions that Kosciusko County has built up since the beginning of time—or at least for the last 78 years?"

That is no exaggeration. Right now, in a backwoods county in the Missouri Ozarks, there is a courageous editor who, with the little newspaper which he prints in the basement of his home, has for several years blocked a bond issue to build a grand new courthouse.

"We are too poor," he argues. "Our neighboring county almost next door has a new $250,000 courthouse. Our county and three or four others ought to combine with our neighbor and help use it before it's out of date."

You would think that at least the big taxpayers would be grateful to this editor. But are they? No! They are punishing him by refusing to advertise in his paper. Usually that is enough to whip any editor into line, but, because this editor is very old and he has enough money to last for the few years left to him and, anyway, he prefers to go fishing, he is perfectly happy. If he had to set up "ads" as well as news he wouldn't have so much time to fish.

No matter how selfishly the politicians nor how sentimentally the people insist on clinging to the old multiple forms of government, we are today getting a large amount of reorganization and consolidation, whether or not there is a general awareness of the significance of what is taking place.

It has been said that the old basic theory of the survival of the fittest works in business but not in government because, if government cannot pay its way, it can always float a bond issue or discover some new source of tax revenue. But there is a limit to all things, even to the ineptness of government.

Is it not consolidation when cities and counties surrender essential services to states, and states surrender essential services and responsibilities to regional authorities and to the national government? And has not this very thing been going on for several years at an increasingly rapid rate? We have been backing into reorganization of governmental units for the very obvious reasons that the national and state governments have been seizing on all the new sources of taxation while, at the same time, legal or economic limits make it impossible for the local units to foot the ever-increasing bills for service.

We are not ready to say we will burn our own garbage, dig wells in our back yards, get along without fire and police protection, be satisfied with less schooling for our children, or fewer public hospitals and lower health service standards. What we want is more and more service.

Perhaps we should ask ourselves whether the kind of reorganization and consolidation we are getting through the pressure of economic necessity is the kind we want. Some who have gone deeply into this problem are not so sure that this process should be permitted to continue until local self-government becomes a mere fiction and an empty shell.

Essentials of County Plan

It should be perfectly obvious to everyone who looks at the situation, especially as it has been magnified by the lens of economic collapse, that the alternative to the piecemeal surrender of services to larger units is through reorganization of governmental units along these general lines:

1. Single important administrative units large enough in population and wealth to render essential services efficiently.
2. Centralization of responsibility in these units, with well-defined authority at the head of each.
3. In so far as possible, the unification of tax-raising and tax-spending activities.

4. The establishment of adequate control of expenditure through proper budget procedure.

There should also be careful consideration of the effect of governmental reorganization upon state-local relations. There are many aspects to this question, as there are many kinds of reorganization. In its simplest form, we find reorganization of local government involving the change from a bad form of government to a good one in a single city. Here we may find a picture something like this: an efficient, well-run city government within the boundaries of a state where the state government is political and poorly administered and where most of the municipalities are operated on the spoils system rather than the merit system. The example of such a city is bound to spread if it is let alone. But letting that city alone involves important state policies. Practically speaking, constitutional municipal home rule is likely to be necessary for the protection of such a city. This is evident from the tremendous expansion of the manager form in home-rule states like Ohio, Michigan and California, and the relatively few manager cities located within non-home rule states.

Inevitably, the same tendency toward home rule for counties will manifest itself in states where a real effort to improve the government of a given county has taken place. In New York, Ohio, California and Virginia, "county home rule" is the cry. Counties primarily are agents of the state, administering functions generally considered state functions. There is a serious question as to the desirability of cutting them loose by means of home rule. But if counties through local self-government begin to become efficient, responsive, democratic agencies, they will demand more home rule rather than less. Under these conditions, the state will do little more than set standards.

On the other hand, if we consider reorganization from the standpoint of alteration of existing areas, or include the transfer of functions from the county to the state, such as is taking place especially in Virginia and North Carolina, then reorganization will result in the gradual elimination of local governmental units as we now know them, and the state will emerge as the all-powerful. There seems no logical reason why this should not happen in states which are fairly homogeneous and not too large in area.

There is, after all, a lot of fiction in home rule. It is the local politician's first war cry when his patronage is threatened. And what use is made of it in most places? It is more honored in the breach, perhaps, than in the observance. Have citizens of North Carolina lost anything by the transfer of functions to the state? Perhaps it is too early to tell. But Professor Paul Wager, firm believer in home rule, writing in the *National Municipal Review,* was unable to discover much feeling of loss on the part of North Carolina citizens, but rather a general conviction that the services so transferred were being administered with much greater efficiency and effectiveness. On the other hand, it must be appreciated that North Carolina has a long tradition of effective state government, a tradition matched by few states.

We may grant that the ideal situation would be for the government that spends the money to raise the money. It may be possible in some states for this ideal to be realized within the limits of local government. But, in most states, the concentration of wealth in certain sections makes state aid necessary unless state government is to be strengthened at the expense of local government. There is more than money at stake here. The very preservation of democracy may be bound up in the preservation of the small units of

government. We do not yet know. We can but watch the experiments going on in various places, observe the different solutions to the same problem, and endeavor gradually to extract from experience sound principles for future action.

CHAPTER XV

GOVERNMENTAL REORGANIZATION AND INTERGOVERNMENTAL RELATIONS IN VIRGINIA

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INTRODUCTION

GOVERNMENTAL reorganization, and discussion of reorganization, in Virginia has assumed five fairly distinct forms:

1. Internal administrative reorganization, which includes the state reorganization of 1928, and the development of city, town and county manager and county executive government;
2. Revenue source segregation, which, although stated in fiscal terms, has in practice altered radically state-local relations in and of itself, and has affected profoundly the entire subsequent course of the local government reorganization movement;
3. Functional reallocation, including the transfer of county roads to the state, increased state responsibility for public education, public assistance and public health, and the cooperation of state and local authorities in administering certain functions on a broader tax, population and geographic base;
4. The rapidly growing planning movement, which is tending, because of their lethargy and ineptitude, to by-pass local governments as pre-planning agencies in even public works and land-use planning of primarily local incidence;
5. Geographical consolidation of local governments, about which much has been said and written and nothing actually accomplished.

While it may be admitted that, from the standpoint of philological consistency, certain of these forms might be

objected to as examples of governmental reorganization, it is clear that in the practical administrative process revenue source segregation and the passing of the planning function to the state are of at least equal importance to the general problem of over-all governmental structure as are measures more precisely identifiable as "governmental reorganization." Since the purpose of this paper is to analyze existing administrative realities and their implications for the over-all problem of structure, such terminological objections have been disregarded.

Internal Administrative Reorganization

1. *State Administrative Reorganization*

In 1926 the then New York Bureau of Municipal Research, under the able direction of our colleague, Dr. Luther Gulick, made a comprehensive survey of state government and administration in Virginia. This survey disclosed, among other things, that state "administration" in Virginia consisted of 27 constitutional agencies and 68 statutory offices—a total of 95 administrative units—loosely hung together and in fact almost entirely uncoordinated.[1] The governor, *qua* governor, was an interested, though largely impotent, bystander in the actual administrative process, and whatever real integration that was secured came almost entirely from the "invisible government," i.e., from the governor's authority as at least nominal head of the controlling faction of the State Democratic Party.

The New York Bureau suggested the substitution of centralized and responsible administration, organized in twelve departments, for this chaotic and meaningless way of carrying out the mandates of the people's elected represen-

[1] New York Bureau of Municipal Research, *Organization and Management of the State Government of Virginia,* p. 6.

tatives.[2] To do this, extensive constitutional amendment was necessary, and in 1928 the people of Virginia adopted changes which sanctioned the major part of the Bureau's proposals.[3] Supplementary to the proposed constitutional amendments, the 1927 General Assembly passed an omnibus bill ostensibly reorganizing those phases of the state administration the alteration of which did not require constitutional change.[4]

The reorganization of 1928 did a good many very salutary things for Virginia state government. It reduced the number of independent collecting and disbursing agencies from forty-eight to one. It set up fairly satisfactory accounting control of state and county finances, except those of county fee officers. Most importantly of all, it set Virginia's face in the right direction in insisting upon the need for regarding the public service as a single enterprise, made up of parts that ought to function integrally.

On the other hand, the substantial integration of administration resulting from the constitutional amendments and reorganization act has not been very significant. The recent personnel classification survey, completed in June, 1937, for example, was compelled to negotiate with 78 different agencies in the course of its field work, because department or agency heads did not feel that they could properly issue administrative orders in respect of personnel affairs to their nominal subordinates directing bureaus and divisions of the "reorganized" departments.[5] The report of the classification survey points out, further, that:

> Practically every state that has adopted an administrative reorganization plan on paper has soon after been content to rest upon its oars,

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[2] *Ibid.*, pp. 7–8.

[3] The joint resolution proposing the constitutional amendment may be found in *Acts of Assembly 1927*, Ch. 32, pp. 46–103.

[4] *Ibid.*, Ch. 33, pp. 103–122.

[5] Griffenhagen and Associates: *Report on a System of Personnel Administration for the Commonwealth of Virginia*, p. 68 (Richmond 1937).

regarding administrative reorganization as a *fait accompli* after reaching but a part of the objectives and realizing but a part of the benefits in view. Often the purported consolidation of two or more departments or agencies into one, by legislative act, has amounted to little more than a gesture because the separate units, consolidated in name, have continued to operate with substantially the same degree of independence as before. This has been due principally to the rather naive assumption that two or more agencies nominally united under one name have become one agency in fact just as soon as the law operates to designate them as one. The need for establishing a unified departmental organization and integrating the various operating procedures has very generally been overlooked.[6]

Obviously, it is extremely superficial to compare over-all statistics as to the number of agencies that are virtually autonomous with regard to internal affairs, and nothing is proved by pointing out that the 95 independent units unearthed by the New York Bureau in 1927 are only 17 more than the number discovered by the personnel classification survey of the "reorganized" state government ten years later. New agencies have been created which, at least in certain particulars, could not well integrate their operating procedures with previously existing units—notably the Alcoholic Beverage Control Board, which is a state trading undertaking, and the Unemployment Compensation Commission, the independent status of which was virtually Federally prescribed. What is needed is a bill of particulars against the accomplishments of the state government reorganization movement in Virginia to date. Wherein, specifically, lie the major defects of existing structure?

In the first place, the governor has an impossible job. Even if he were completely without political responsibility in the leadership of his party—even if his entire attention could be devoted to the over-all management of the state administration—the task with which he is currently charged is a superhuman one. "The nearer to the top of

[6] *Ibid.*, p. 69.

an organization you get," Dimock has written,[7] "the simpler should be the communication and control relationships. Get clogged up at the top, and the wheels will slow down all along the line. The higher the quality and the larger the responsibilities, the smaller should be the number of immediate subordinates; at lower levels, on the other hand, where the performance of specific tasks is all that is delegated and not the supervision of others, the number of relationships may well be larger."

How many subordinates can the governor be expected to deal with directly? Sir Ian Hamilton set three to six as the maximum number for the supreme command of the British Army;[8] L. Urwick, currently the *grand patron* of the scientific management movement, says four for those at the top, and eight to twelve for those at the lowest executive level;[9] Henri Fayol says five or six;[10] Luther Gulick said twelve in 1927 in the New York Bureau's survey of Virginia,[11] and twelve again in 1937 as a member of the President's Committee on Administrative Management;[12] and the British Machinery of Government Committee reached about the same conclusion.[13] Without incurring the necessity for adding to the interesting numerological experiments which have produced these magic numbers, it is clearly evident that the effective span of

[7] Marshall Dimock: "Executive Responsibilities," *The Society for Advancement of Management Journal*, Vol. III, No. 1 (January 1938).

[8] Sir Ian Hamilton: *The Soul and Body of an Army*, pp. 229-230 (London 1921).

[9] L. Urwick: "Executive Decentralization and Functional Coordination," *Public Administration*, Vol. XII, p. 348 (October 1935).

[10] Henri Fayol: "The Administrative Theory in the State," in L. Urwick and Luther Gulick, *Papers on the Science of Administration*, p. 110 (New York 1937).

[11] *Organization and Management of the State Government of Virginia*, p. 7.

[12] *Report of the President's Committee on Administrative Management*, p. 31 *et seq.* (Washington 1937).

[13] Ministry of Reconstruction: *Report of the Machinery of Government Committee*, p. 5 (London 1918).

control of the governor of Virginia is very much less than 78. It is encouraging to note that the governor-elect has taken a decisive step toward putting his office in order by the appointment of an administrative assistant; [14] but unless vastly more substantial integration is obtained in operating procedures of the twelve "departments" of the state government, their coordination will demand the services of even more executive assistants than the governor can himself deal with effectively. The problem is actually that bad.

Proceeding to specific examples of departmental malorganization, it may be observed that the Department of Finance which the reorganization act purported to establish has never become an integrated department from a functional point of view. The New York Bureau suggested that the director of the budget be made the head of the Department of Finance, but this was not done. The director of the budget heads a division in the Executive Department, while the governor is himself theoretically the head of the Department of Finance, consisting of the divisions of accounts and control, motor vehicles, treasury, and purchase and printing. Harry Byrd, father of reorganization and Governor of the Commonwealth at the time of the state reorganization, himself vigorously opposed the "dangerous centralization of power in the hands of a single individual" which he believed the proposal for an effective program of financial centralization involved.[15] It would seem that the power, if dangerous, would be as dangerous in the hands of the governor as of any other "single individual." This, however, is only an academic argument, since the function has never paralleled the power; no governor has ever had the time or inclination to act, in the

[14] *Richmond Times-Dispatch* (January 7, 1938) p. 1.

[15] James E. Pate: *State Government in Virginia,* p. 124, n. 8 (Richmond, 1932).

technical sense, as director and coordinator of the Department of Finance. Moreover, a number of distinctly nonfiscal functions have been left in the Department of Finance, which has resulted in a definite lack of integration between motor vehicle taxation and the other tax functions of the state government, between the state police and other safety activities of the state, and in various other phases of state administration.

The evolution of the "reorganized" Department of Public Welfare likewise leaves a good deal to be desired from the standpoint of integrated administration. Under the first post-reorganization director of the department, a definite trend toward centralization and integration was established. While separate institutional, and in some cases functional, boards were retained under the reorganization act, the *ex officio* membership of the director of public welfare on such boards was transmitted, by the sheer virtue of superior knowledge and information, into an effective type of administrative coordination. A department of the state government, designated as a department although *de jure* disintegrated, seemed in a fair way to become *de facto* an organic unit. With the accession of the second post-reorganization director, however, the trend was definitely reversed. *Ex officio* membership on institutional and functional boards was resigned or, on motion of the director, abolished by legislative action,[16] so that the State Department of Public Welfare became a mere term of polite nomenclature; it actually consisted of the division of public assistance, the division of jails, the penitentiary, the commission for the blind and, prior to the creation of

[16] "The ex-officio membership of the Commissioner of Public Welfare on the hospitals and prison boards was done away with by the General Assembly in 1934—in an effort to reestablish the independence and integrity of the office. . . ." *Report of the State Department of Public Welfare 1935*, p. 5 (Richmond, 1935). See also *Acts of Assembly 1934*, Ch. 296, pp. 476–477.

the General Hospital Board, four completely independent state hospitals for mental patients. All of these went their several separate ways in complete disregard of one another, and the resulting chaos was, in the words of one commentator, "utterly magnificent."

Other examples of disintegration are not lacking. The so-called Department of Conservation and Development is actually three separate and uncoordinated departments—conservation and development, ocean fishery, and game and inland fisheries. Twenty-six institutional and examination agencies attached to the Department of Education, but in fact operating with only the most casual relations to the Department, cumulate the picture of disorganization. Three "associated agencies" of the Department of Health and 27 "special boards and commissions" complete the chaos of state administration. Of such is constituted the government to which editorialists throughout the nation habitually refer under the rubric, "Virginia: There She Stands!"

Equally evident is the fact that Virginia has not made up her mind regarding the sort of executive direction of state agencies which she prefers. The Alcoholic Beverage Control Board, the Department of Labor, the Unemployment Compensation Commission, the Commission on Conservation and Development, and several others are headed by three or more full-time commissioners. The Department of Highways and the Division of Inland Fisheries boards are composed of unpaid part-time commissioners with a full-time chairman. The State Board of Public Welfare, the State Board of Agriculture and the State Board of Education are composed of commissioners with *ex officio* secretaries or executive officers. Although for practical administrative purposes, most of the important line agencies and divisions are headed by full-time officials,

more or less professionally qualified, the extensive use of directory, policy and advisory boards injects a distinct impediment to truly integrated administrative functioning. The lack of a clear-cut policy in respect of the prerogatives and functions of boards constitutes an important element in the chaotic state of the over-all administrative structure of state government.

The failure of administrative reorganization effectively to centralize tax administration is likewise an important factor to be noted.[17] The State Corporation Commission still assesses the properties of public utility corporations subject to local levies, and certifies to the local authorities an amount which it fondly hopes is 40 per cent of the true value of utility properties locally taxable. Because of revenue source segregation, which will be discussed later, municipal and county assessment ratios vary from 15 to 90 per cent of true values. So that in some localities the public service corporations bear almost the entirety of local government costs, whereas in others the contribution is negligible in comparison with the cost of servicing the properties of such corporations. As we have indicated above, the Division of Motor Vehicles in the Finance Department handles the licensing of motor vehicles throughout the state, through the central Richmond office and a number of local offices, without reference to the Department of Taxation's local commissioners of the revenue. As the New York Bureau's report points out, "Tax information has a way of fitting together in such a manner as to form a check upon itself." [18] Certainly, the information routinely collected by the Division of Motor Vehicles relating to types of, and purposes for which, motor vehicles are licensed would naturally integrate itself in the local assessment of

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[17] See William H. Stauffer: *Taxation in Virginia,* p. 83 *et seq.*
[18] *Report, op. cit.,* p. 61.

personalty, as well as certain phases of local licensing. But existing administrative arrangements impede, if they do not altogether prohibit, this very necessary "fitting together" process.

In failing to professionalize the personnel for the assessment of state taxes, the state has condemned both itself and the vast majority of its subdivisions to a perpetuation of the rule-of-thumb, hit-or-miss, politically dictated tax assessing which has characterized state and local government in America for many years.[19] The commissioner of the revenue in Virginia counties and cities is an elective officer. In respect of local assessments he is of course the agent of the county or city. But he also handles virtually all state tax assessments in his locality—with certain exceptions which have been noted above—and is hence an important link in state fiscal administration. Indeed, it is doubtful whether a comparable degree of administrative devolution in the assessment of state taxes is to be encountered anywhere else in the country. In Virginia the state pays a considerable part of the cost of the Commissioner of the Revenue's office, and hence is in an extremely strategic position to impose professional requirements and qualifications. By failing to impose these requirements, and by continuing to rely upon elective local officials with primarily political qualifications, the state has not only compromised seriously the effectiveness of its own financial

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[19] New York Bureau of Municipal Research, *County Government in Virginia,* p. 45: "We would recommend, likewise, that commissioners of revenue be made appointive. The work of assessment requires a certain amount of technical knowledge and experience. The voters have never shown themselves very apt at the election of men with such qualifications. Then, again, the work of assessment must be carried out without fear or favor. This is easier if the assessor is not responsible directly to the voters. There is ample experience in cities and in states like New York and New Jersey, where both systems are in operation side by side, to show that the appointive assessor system is more satisfactory to the voters and more efficient than the elective system."

administration, but has removed most of the incentive for scientific assessment and better over-all financial administration in the local governments of Virginia.

Equally objectionable from the standpoint of state-local administrative and fiscal relationships has been the neglect of reorganization to reform penal administration,[20] Local jail and detention functions, even for offenders against state laws, remain in the hands of locally elected sheriffs, whose main source of income is the profit derived from the care and feeding of prisoners. The state pays a fixed per diem for the care of offenders charged with violations of state laws.[21] Numerous investigations have indicated that this amount is from 50 to 80 per cent profit for the jailers.[22] The problem as to whether the prisoner is a state or county prisoner depends entirely upon the charge. Since the local board of supervisors is near and Richmond is far, there is a definite tendency for prisoners to have offended the laws of the Commonwealth if they have, indeed, broken the laws at all. In effect, local sheriffs are given blank checks on the State Treasury, and the only limitation placed upon their discretion is the willingness of the auditor of prison accounts—whose office is totally unprepared to make an audit inspection with teeth in it—to accept their hypotheses of local penal costs. The aggregate result has been, not unnaturally, to pyramid penal commitments in Virginia in recent years. Last year one in every thirty inhabitants of Virgina went to jail—statistically speaking.[23] This rate is *four times* the national average. We are spending considerably more money out of the state general fund for getting and keeping people in jail than we are for higher

[20] Legislative Jail Committee, *The Virginia Jail System, Past and Present, with a Program for the Future,* pp. 12–13.

[21] *Code of Virginia,* Sec. 3510.

[22] See F. W. Hoffer, D. M. Mann and F. N. House: *The Jails of Virginia,* p. 98.

[23] Legislative Jail Committee, *op. cit.,* pp. 10–11.

education. The reason is not that Virginians are notoriously criminal, or that they are particularly incapable of absorbing the higher learning. It is simply that the state pays a bonus for putting people in jail.

The sheriffs are, at the same time, responsible for the performance of the local public safety function. This phase of the job is totally unremunerative, and any expenditure for it reduces the profits from the care of prisoners. It is not surprising that a good many counties have been compelled to employ, and pay from tax funds, county policemen, who operate largely independently of the sheriff's office. More generally, however, the public safety function simply isn't performed, in the sense that organized patrols and crime prevention activities are completely lacking.[24] The police function, in rural Virginia at least, is an ex post facto operation. Crime prevention is conspicuously neglected, because it costs money and makes no profits for the sheriff; it is, indeed, entirely inconsonant with current conceptions of the nature of the office. So that, in addition to squandering a goodly amount of the people's money in sending people to jail who should never actually be put in jail at all, and keeping people there who should be paroled, the failure of the state properly to reorganize its penal administration has perpetuated in the localities a wholly inefficient and totally inadequate system of public safety administration which daily grows more alien to the social realities with which local government is confronted.

In summary, state administrative reorganization in Virginia has contributed little, if anything, to the development

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[24] Bruce Smith: *Rural Crime Control,* pp. 36–74; also an unpublished study by Rowland Egger, Raymond Uhl and Vincent Shea of county administration in the lower York-James peninsula counties of Virginia, made in 1937: "There is ample evidence that the criminal aspect of the sheriff's work is of secondary importance in the eyes of most of the incumbents of the sheriff's office." New York Bureau of Municipal Research, *County Government in Virginia,* p. 51.

of an efficient and economical over-all pattern of government in the Commonwealth. It has failed to professionalize its own personnel. In its activities of local incidence, it has continued to work through politically, rather than administratively, qualified local officers and agencies, and in so doing has impeded, rather than facilitated, the reorganization of local, particularly county, government. State-local relations run from state agency to particular local officers, usually elective—not to the county or municipality in its corporate character. All this does very little to advance the organization of local government as an integrated and responsible local undertaking.

2. *Growth of City and Town Manager Government*

The principles of council-manager government as applied to urban units are too familiar to students of public finance and administration to require reiteration at this point. It is enough to point out that since the plan was first adopted in Staunton in 1908, twelve of the fourteen cities of the first class (those having over 10,000 population) have adopted the plan. Richmond and Danville are the only two large cities in Virginia not under the council-manager scheme. Five of the nine cities of the second class (those having populations between 5,000 and 10,000 and also, because of ancient charters, Williamsburg and Buena Vista) operate under council-manager government. Eighteen of the 178 active towns * in the Commonwealth have council-manager government.[25] Of course, the substance of council-manager government varies considerably from city to city

* Editor's Note: It should be borne in mind by readers that towns in Virginia are large villages and are not similar to the subdivisions of a county known as "towns" or "townships" in some of the Northern and Middle Western States. Such local subdivisions are unknown in Virginia and most of the Southern States.

[25] See International City Managers' Association: *The Municipal Yearbook, 1936,* pp. 243-244.

and from town to town. In at least one of our larger cities the manager plan is a flimsy window-dressing for the most arrogantly political administration the locality has ever had. In general, however, council-manager government tends, in Virginia, to be centralized and responsible administration, honestly conducted by men who are good engineers and fairly acceptable administrators.

Unfortunately, legislation relative to council-manager government in the cities and towns does not, as does the Optional Forms Act for the government of counties, which will be discussed later, permit the cities and towns to integrate and fully professionalize the functions normally performed by elective commissioners of the revenue. It is fairly accurate to say that the local assessment function in all cities and towns continues to be performed by elective officials, with all that that implies, and that the municipalities themselves are not statutorily authorized to remedy the situation.

In short, the single significant fact for the problem of intergovernment relations which is produced by the development of city and town manager government is that in doing their own jobs better the local authorities are, in some particulars, enabled to do a better job of devolved state administration which falls to their lot.

3. *County Manager and County Executive Government*

Virginia has three of the six authentic centralized-executive plans of county administration in operation in the United States. Two of these, Henrico and Albemarle, were adopted under the terms of the Optional Forms Acts passed by the General Assembly in 1932.[26] The government of Arlington County is conducted under a special act originally passed in 1930.[27]

[26] *Acts of Assembly 1932,* Ch. 368, pp. 727–752.
[27] *Acts of Assembly 1930,* Ch. 167, pp. 450–456.

The essentials of all three plans—the Henrico manager plan, the Arlington manager plan, and the Albemarle executive plan—are identical. The policy-determining function is vested in a board of supervisors nominated from magisterial districts but elected at large. The board's functions are greatly enlarged over those of the old law boards, since it normally controls the appointment of major county officers. The board determines policy, enacts legislation, makes appropriations, levies taxes and directs and supervises in a general way the activities of the county. With regard to the appointive power, the Albemarle board appoints all county officers, with the exceptions above noted, without reference to the board, in Henrico the manager appoints administrative officials, while in Arlington the treasurer and commissioner of the revenue are also elected and, hence, not under the control of the county board. In Henrico and Albemarle, it may be noted, the sheriff is a salaried officer, and through its power in setting his compensation the county board exercises considerable authority over the sheriff's office.

The most important function of the board, however, is the employment and supervision of the county executive or county manager. This official is the budget officer of the county, and the agent of the board in the execution of the board's policies. Obviously, his authority is no greater than the board's authority, so that the manager in Arlington is necessarily less completely in control of administration than the manager in Henrico or the executive in Albemarle.[28]

From the standpoint of inter-governmental relations, the most interesting feature of the governments of Albemarle

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[28] See in this connection Cedric Larson: "Six Years of Managership in Arlington County, Virginia," *National Municipal Review*, Vol. XXVI, pp. 531–537 (November, 1937).

and Henrico is that the county board has the power to centralize and professionalize county services, including those services which are partly county and partly state. The Optional Forms Act provides for the setting up of departments of finance, public works, public welfare, law enforcement, education, records, and health, and allows optionally the establishment also of a department of assessments (which would otherwise be merely a bureau of the department of finance) and a department of home and farm demonstration. Under this act Henrico has, for example, completely professionalized its assessment procedure and eliminated the elective commissioner of the revenue, and has also professionalized its police force, through reducing the sheriff (by virtue of the board's control over his salary) to a process-serving officer and the appointment of a regular full-time police force. In both Henrico and Albemarle the county itself, instead of the sheriff, receives all fees for the service of writs and processes and all profit from the care of state prisoners. This is true also of fees received by the clerk of the courts, who becomes a salaried employee under both of the optional forms. It may be worthy of note that Henrico County has the most comprehensive merit system of personnel administration of any governmental unit in the state.

Equally significant is the fact that under the Optional Forms Act the county board of supervisors appoints outright the county school board, whereas normally the school board is appointed by an "electoral board" appointed by the judge of the circuit court. The Act has brought educational administration, and the education budget, back into the fold with the rest of the government services—where it properly belongs. And to the degree that education may still be spoken of as a local function, it has tended to integrate educational programs and facilities with the other

county service functions. It is perhaps worthy of note that two bills in the present General Assembly provide for the extension of this principle to all counties in the state,[29] and that the inaugural message of the governor spoke of the desirability of a county board which would have jurisdiction over "all affairs of the county." [30]

Experience to date indicates a considerable decrease in both state and local costs of financial administration as a result of centralization and professionalization of finance personnel in Albemarle and Henrico, while the general impression is that substantially more effective work in the handling of both state and local business is being performed. The fiscal responsibilities of the state in the matter of penal administration are not affected by the reorganization plans. The development of crime prevention programs and the professionalization of the police personnel, plus the removal of the profit motive in the commitment of prisoners as a result of the remission of all profits to the local government, has had some effect on the number and cost of commitments, although fundamental reorganization of the entire system of penal administration remains one of the outstanding problems of both state and local governments.

Segregation of Revenue Sources

The Virginia Constitution of 1902 authorized the segregation of revenue sources to state and local uses on and after January 1, 1913.[31] Several legislative commissions attempted, between 1910 and 1914, to develop acceptable schemes of separation, but were uniformly unsuccessful. In

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[29] Session of 1938, House Bill No. 24 and House Bill No. 33.

[30] "It seems to me that a great improvement in county government can be made by investing the Board of Supervisors or some similar board with the responsibility of managing all the affairs of the county, including the schools." Inaugural address of Governor James H. Price, as reported in *Richmond Times-Dispatch* (January 20, 1938), p. 7.

[31] Constitution of 1902, Article XIII, Section 169.

1915 a partial segregation plan was adopted by legislative act which allocated real estate and tangible personalty to local uses, the sole state claim against such types of property being a 10-cent levy for public schools. Intangible forms of property were, by the same act, assigned to state use primarily, and very low maximum rates against such types of property were established for local authorities wishing to impose a levy against them.[32] The state was unable to stick to its part of the bargain, however, so that by 1919 the state levy on real estate was 25 cents, instead of 10 cents—or within 10 cents of the maximum state rate that had ever been imposed under the state general property tax.[33]

The failure of the state to keep out of real property taxation, and the increased governmental expenditures entailed by the post-war multiplication of public functions, produced more and more agitation by real property owners for substantial tax relief—particularly for repeal of the state levy on real estate. The Commission on Simplification and Economy in State and Local Government of 1924 approved this appeal for the relief of real estate, but did not embrace segregation as the remedy. Indeed, the Commission's report points out that "complete segregation usually brings with it evils and dangers no less serious than those it is intended to remove." With a fine sense of realism, the Commission proposed the creation of a full-time, professionally qualified tax board, with power to equalize the assessments of the cities and towns throughout the state.[34]

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[32] *Acts of Assembly 1915*, Ch. 63, pp. 84–86.

[33] The increase in the state levy was due to the special tax of 8 cents for public free schools, for roads, and for the eradication of tuberculosis imposed by *Acts of Assembly 1918*, Ch. 384, pp. 569–572, and the special tax of 7 cents for roads imposed by *Acts of Assembly 1919*, Ch. 25, pp. 38–40. These were, of course, in addition to the regular levy of 10 cents for the general purposes of the state government.

[34] *Report of the Commission on Simplification and Economy in State and Local Government*, p. 128.

This suggestion went unheeded, and, as Dr. Stauffer correctly remarks, "An opportunity was lost after a period of educational effort covering nearly fifteen years to bring into operation certain very wise and worthy recommendations for the improvement of property assessments.[35]

In 1926, however, the General Assembly took the easy and superficial way out, and adopted a complete segregation plan under which real estate and tangible personal property, excepting the rolling stock of steam railroads, were reserved exclusively to the counties and municipalities.[36] Intangible property was similarly reserved to state use. Two years later the people of the Commonwealth, with the able leadership of the real estate interests in the state, embedded in the legal granite of the state constitution a perpetual injunction against the taxation of real estate by the Commonwealth.[37]

This action has produced three important results:

1. It has abdicated the responsibility of the state for the proper assessment of property by its political subdivisions; and thereby established an assessment of real estate as grossly inequitable, unscientific, and politically dictated as any to be found throughout the country;
2. It has put the counties and cities in a fiscal straitjacket, which, with additional taxes necessitated for old age assistance and other phases of the social security program, bids fair to undo the purposes for which segregation was adopted;
3. It has transferred the struggle for real property tax relief from the field of finance to the field of functional allocation, which is contributing very handsomely to the process of functional erosion perhaps destined to wipe out the very institution of local self-government in Virginia.

Unless real estate, scientifically assessed at full value, can again be justly reintegrated in the over-all picture of state

[35] *Op. cit.*, p. 80.
[36] *Acts of Assembly 1926*, Ch. 576, pp. 955–998.
[37] Constitution of Virginia, Article XII, Section 171, as amended in 1928.

and local taxation in Virginia, by the establishment of an adequately powerful state tax board with broad powers of administrative supervision of our local authorities, revenue source segregation may well prove, in the years that are ahead, to be one of the most disastrous experiments ever undertaken in Virginia government.

Functional Reallocation

We have referred above to the effect of segregation on the allocation of functions between state and local governments in the Commonwealth. The first, and most dramatic, example of this trend was the Byrd Road Plan, embodied in the Harman Act of 1932 and enacted as a palliative to real estate which, theoretically, had been disposed of in the segregation act of 1926 and the amendment of 1928.[38] But realty did not stay relieved. Under this legislation, responsibility for the construction and maintenance of all county roads and all streets in towns which had fewer than 3,500 population according to the census of 1920 passed to the state. These 38,000 miles of secondary roads had previously been financed from the one-third of the proceeds of the gasoline tax allocated to counties, which aggregated about $3,200,000 a year, plus local road taxes levied on real property, which, excluding debt charges (which were not transferred to the state) came to about $3,400,000. The idea was that the localities could repeal the rates hitherto levied for road purposes, while the state would keep the amounts of gas tax money hitherto allocated to the counties and, by realizing the economies of centralized administration—to say nothing of making inroads on funds which had before been used for the development of the primary system—handle all roads in the state with the total income

[38] *Acts of Assembly 1932,* Ch. 415, pp. 872–880.

from gasoline taxes. This interesting bit of flying-trapeze work has likewise had three important results:

1. It has necessitated the neglect of the primary system in many parts of the state;[39]
2. It has made the State Highway Commissioner the whipping-boy of local Chambers of Commerce, Citizens' Associations, Highway Associations and every other organization out to do something "big" for its community or region;
3. It may result in that apotheosis of asininity, a constitutional amendment allocating gas tax revenues exclusively to the construction and maintenance of highways.[40]

In the "Big Push" occasioned by the news that the General Fund of the Commonwealth would have a surplus of $5,000,000 at the end of the present fiscal year, education, among other functions, has again raised its voice for more state money. If past experience means anything, a renewal of the movement to transfer the instructional function in toto to the state budget may well be expected.[41] Only the housekeeping and co-curricular phases of the school program would then be left with the local authorities. It is by no means unlikely that such a functional reallocation may be realized, and that virtually complete responsibility for the financing and control of the actual teaching of all public school children will be passed to the Commonwealth. This would solve a good many knotty problems; the state's "distressed areas" could be dealt with on a much

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[39] An interesting outgrowth of this condition is the recommendation of the Virginia Advisory Legislative Council in its report on *Highway Safety and Other Matters Relating to Motor Vehicles* of specific amounts to be allotted by the General Assembly over a ten-year period for the completion of the primary system in the eight highway districts of the state. See p. 72 *et seq.*

[40] Such an amendment has been seriously discussed by the Virginia Good Roads League, although Governor Price, in his inaugural message, while opposing diversion of motor fuel tax revenues and motor vehicle license taxes from highway construction and maintenance, emphatically repudiated further "earmarking" of revenue sources.

[41] Such a bill has actually been introduced in the 1938 session of the General Assembly; see Senate Bill No. 15.

more elastic basis than is now possible with cumbersome "equalization" formulæ for educational grants-in-aid. On the other hand, it permanently absolves real estate, which many competent observers believe to be, in the aggregate, quite moderately taxed as compared with other sources of state and local revenue in Virginia, from any responsibility in the financing of the big item of public education costs. And it is undeniably a very considerable bit of functional erosion.

The non-Federal share of public assistance and social security costs in Virginia is also tending to be placed very largely upon the state budget.[42] Dr. Stauffer has already discussed the subvention problem and its relation to a workable pattern of state and local finance and administration, and I do not propose to take that question up here. At the same time, it must be evident that the continued resistance of the local authorities to the bearing of their part of the cost of the newer social services will eventually, if successful, result in an intolerable distribution of the tax burden under the Virginia segregation plan, topheavy and over-centralized administration, and the atrophy of local institutions.

The rural public health function, to which reference has already been made, is tending to pass to the state in units covering more than a single county.[43] Since most Virginia counties are too small economically to utilize a full-time health organization, these multi-county units will probably type public health organization in the state. It must be admitted frankly that the counties have completely

[42] See identical old-age assistance bills, House No. 63 and Senate No. 42; also identical dependent children bills, House No. 26 and Senate No. 40; also identical blind aid bills, House No. 25 and Senate No. 35.

[43] See in this connection the Report of the Committee on Taxation and Government of the Virginia State Chamber of Commerce, appearing under the title "Virginia State Finances 1929–1937," *The Commonwealth,* Vol. V, pp. 5–12, at p. 10.

defaulted in the public health function. Where there is any rural health work in Virginia, it is due largely to the state, the Federal Government, and the foundations. In attempting to provide rural health service, however, the state has adopted a policy which abrogates local responsibility. Local contributions are accepted, but most of the money in the typical joint unit comes from the Federal Government and the state. Administration is completely in the hands of the State Health Department, which appoints the director and through which all employees are paid. The local health boards are reduced to a cipher, with only nuisance value. Their primary function seems to be constantly at the heels of the director with demands for additional services without regard to resources, population, or the public health problem in the several counties. No permanent, constructive interest in the local public health problem is being built up, and there is no sense of local responsibility for the state of the public health. Health administrators have long realized that the most potent single force for the improvement of local health and sanitary conditions lies in an awakened popular interest and sense of public responsibility. But the rural health function in Virginia moves, when it moves, largely without the assistance of popular support.

Somewhat more hopeful are other trends in functional reallocation. The establishment of regional facilities for the institutional care of the aged and indigent has met with spectacular success in Virginia, and there are now no less than four such cooperative undertakings serving 21 counties and cities of the Commonwealth.[44] The cooperation of the local authorities with each other and with the Commonwealth in the development of training progress for public

[44] Raymond Uhl: "Functional Consolidation in the Counties of Virginia," *National Municipal Review,* Vol. XXV, pp. 601–603 (October, 1936).

employees,[45] the cooperation of the cities and towns through the League of Virginia Municipalities in the purchase of equipment and supplies and in the securing of research and informational services.[46] intermunicipal and state-local cooperation in the provision of state-wide facilities for police communication,[47] are notable examples of this largely informal variety of intergovernmental cooperation which is tending to establish certain of the management functions of government on broader and more economically practicable bases. This type of organization for public service must certainly be taken into account in any consideration of developing patterns of functional allocation and intergovernmental fiscal and administrative relations. At the same time, it must be realized that it is merely ancillary to the development of proper organic relations, and, no matter how extensively developed and applied, cannot be expected to overcome fundamental structural defects.

Public Works and Land Use Planning

In Virginia, as elsewhere, public works and land-use planning first acquired comprehensive connotation with the establishment of the State Planning Board, which works closely in contact with the National Resources Committee. Because of the firmness with which the idea of state planning has entrenched itself in the ideology of liberals throughout the Commonwealth, and the variety of practical uses to which the work of the Board has been put, public works and land-use planning in Virginia constitute factors of signal importance in the whole problem of governmental finance and structure.

In the field of public works planning, it is evident that

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45 Rowland Egger, Harold Baumes and Raymond Uhl: *Training for Public Service in Virginia,* pp. 45–58.

46 *League of Virginia Municipalities Year Book 1936–37,* pp. 159–165.

47 See *Acts of Assembly 1934,* Ch. 284, pp. 442–443.

the location of highways and other transport facilities and the construction of schools and educational facilities constitute, quantitatively, the bulk of the problem. Since the passage of the Harman Act of 1932, transferring virtually all public highways in Virginia to the state government, it is natural that the planning function in connection with highways should be transferred to the Division of Surveys, Plans and Estimates of the Highway Department, working in conjunction with the Planning Board.

There is, of course, nothing inherent in this arrangement which would eliminate the local authorities in pre-planning and planning activities. However, legislation has been on the statute books of the Commonwealth for over two years authorizing the establishment of county planning boards in all counties in Virginia. So far as we have been able to determine, no planning board has been established as the result of this general legislation. There are, to be sure, several county planning boards in existence, but all of these derive their powers from special legislation passed to meet the needs of primarily urban counties.

In the matter of school and school transportation planning, the Planning Board and the State Department of Education have for some time been engaged in an elaborate program of spoon-feeding designed to persuade local educational authorities to participate in the planning of these services. The outcome of the experiment is not yet entirely clear, but my guess is that in the end the Planning Board and the Department of Education will have to give the local people up as a bad job and do the planning as a state function.

Land-use planning is likewise contemplated in the legislation authorizing the establishment of county planning boards referred to above. Experience of the last few years, in which the marginal populations of Virginia have cumu-

lated, and in which tax delinquency mainly attributable to marginality has pyramided, would seem to have laid a very thorough groundwork for the proper appreciation by local authorities of the need for land-use planning. But not so. In spite of the clearly demonstrated possibility of preserving taxable values by intelligently pre-planning the conservation of the land from further erosion, loss of fertility, and destruction by fire; of bringing non-productive land back into use through reforestation, improvements in cropping, and development of game preserves and recreational areas; of preventing wasteful private exploitation which demands uneconomical provision of public services; of curtailing speculative development which tends to destroy existing values, virtually nothing has been done. The director of the planning board may exhort and view with alarm, the State Department of Agriculture may solemnly warn, and the Federal Government may attempt to purchase intelligent rural land-use planning through crop loans and subsidies, but still, nothing is done on any scale worthy of being called a local plan.[48]

The result of all this has been a by-passing of the local authorities as pre-planning and planning agencies. There is no reason why Richmond and Washington should know more about what is needed locally than do local officials and local agencies. But the simple fact is that nothing is apparently known, or if known is never socially and coherently expressed, by the "grass-root" governments. So that Richmond and Washington, having at least a smattering of information, are actually in a better position to move forward, and are, in fact, so doing. The outcome is predictable, and apparently inevitable.

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[48] See Charles J. Calrow: "Planning for the Counties," an address before the League of Virginia Counties as reported in *The Staunton News-Leader* (December 10, 1937), p. 2.

Geographical Reorganization of Local Government

The necessity for the geographical reorganization of local government in Virginia has long been the perennially favorite topic of governmental reformers. The average county in the United States contains 986 square miles, while the average Virginia county contains 401. Only two counties of Virginia's one hundred are larger than the national average. Similar differences exist in population. The average American county has a population of 39,992. The average Virginia county has 17,189. Although accurate fiscal data are not available for comparative purposes, it is probable that the divergencies in taxable wealth are at least as great.[49] The obvious fact is that most Virginia counties are entirely too small to maintain a minimum skeletel organization for the effective performance of county functions, while the advantages of functional specialization are completely out of reach for all counties in the state.

The New York Bureau of Municipal Research suggested in 1927 that attention should be given to county consolidation, and pointed out a number of areas in which a strong presumption in favor of consolidation existed.[50] The Virginia Commission on County Government suggested for purposes of discussion, in its 1936 report, a grouping of Virginia's 100 counties in 31 administrative districts.[51] The Bureau of Public Administration at the University of Virginia has recently completed a detailed field survey of county administration in the lower York-James Peninsula which demonstrates conclusively that the counties of Warwick, York, James City and Elizabeth City, when combined, present an administrative problem demanding, in

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[49] Virginia Commission on County Government: *A Further Report on Progress in County Government and County Consolidation 1936,* pp. 40–41.
[50] *Op. cit.,* p. 90.
[51] *Op. cit., supra* n. 49, pp. 42 *et seq.*

several departments of county administration, no more than the minimum personnel and equipment necessary to effective functioning.[52]

In the face of all this good advice, it must be remarked that to our certain knowledge no really positive step has ever been taken in any part of Virginia in the direction of consolidation. Nor is the prospect of significant achievement in this field anywhere apparent. In Warwick and Elizabeth City counties there are two schools located about three miles from each other, but in separate counties. One has fifty pupils in each room, and is literally jammed to the eaves. The other has several vacant rooms fully equipped, and fewer than 20 pupils per room in occupied rooms. But the pupils in the crowded school in Warwick County cannot be transported over the three miles of concrete highway to the spacious school in Elizabeth City County, because in 1634 the Virginia House of Burgesses drew an imaginary line through a dismal swamp. Further, no territorial changes of any significance have been made in this area in 250 years. Such is the power of the dead hand of the past in the Commonwealth of Virginia.

Conclusion

Governmental reorganization in Virginia has created about as many problems in the field of intergovernmental relations as it has solved. This is due in part to the fact that reorganization has, in many particulars, not been carried through to an even reasonably complete stage. It has been due in part to the fact that whatever reorganization that has been effected has been piecemeal, and has not proceeded from an over-all view of the realities of public finance, governmental functions, or social objectives. It is impossible to forecast what reorganization along the lines

[52] *Op. cit., supra* n. 24.

which have been pursued in Virginia might have accomplished, because the whole program—incoherent as it may be in many aspects—has been compromised by the failure of state and local governments adequately to professionalize their personnel.

This much is clear. If administrative machinery capable of functioning effectively and efficiently and productive of the sort of state-local, intercounty and intermunicipal relations which the people of Virginia may deem to be socially desirable is to be secured, a vastly broader conception of reorganization must be embraced than that which has dominated the movement to date. The abortive separatism which makes for a cleavage between state and local governments must be overcome. All the governmental agencies of the Commonwealth, as well as all the agencies within the several instrumentalities, must become in fact parts of a single enterprise, capable of functioning integrally. Governmental "prima-donnaism" is as obsolete as most other varieties of "prima-donnaism," and the capacity to cooperate intelligently and effectively is as much a test of survival-value in government as elsewhere.

CHAPTER XVI

STATE PLANNING AND FUTURE LOCAL REVENUES

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IF some of the newer and more extreme theories of public finance should be generally accepted, and prove feasible, there would be no need for local revenues in the future; since local expenditures would then be financed by grants from the Federal Government. Personally, I am afraid that these theories will not prove feasible and that local governments will continue to need bona fide revenues of their own sufficient to finance their own expenditures.

That is about as far as I can pursue the topic assigned to me with any degree of assurance. If I were to stop here, however, it might place your program committee in an embarrassing position. After all, they had every right to assume that I knew something about the subject. When they extended the invitation to speak, I was just about to complete two years of servitude in a state planning agency. Much of my time had been spent in analyzing local revenues which had been accrued on the tax rolls, and on the general municipal ledgers, but which unfortunately had not yet been collected. If those old levies can be considered revenues at all—which I have come to doubt—they must therefore be looked on as *future* local revenues. In short, circumstantial evidence warranted the assumption that I was qualified to speak on the subject as it had been phrased.

And now, I shall turn my attention toward a topic concerning which, in spare moments, I have given my imagination free rein for some time past. That is: *State Planning, as It Might Be, and Its Probable Effects on Future Local Expenditures.*

What Is State Planning?

How does state planning, as I think it might be, differ from state planning as it is?

Planning, of course, is even older than government. Every state has, since its establishment, resorted to planning in the conduct of its affairs. This kind of planning, however, is quite generally carried on by individual departments in the performance of the tasks assigned to them. Some of this work, incidentally, has been of a very high order, and deserves to be ranked with the best of the work which has been done by members of the planning profession.

Stimulated by Federal Government

Because planning of this type has been conducted on a departmental basis, inevitable conflicts have arisen among the several interrelated plans. The need for coordinated planning on the state level has long been apparent. The recognition of this need, on the other hand, has not yet become sufficiently widespread to explain the sudden emergence of state planning agencies in 46 states. This growth is plainly attributable to the efforts of the national government, and to its liberal aid in support of such activities.

This fact raises another question concerning which I shall also have to resort to guesses. Why did the national government suddenly become so keenly interested in state planning?

One probable reason is to be found in the difficulties encountered by the Public Works Administration in finding

plans on state and local levels which were suitable for the immediate extension of Federal loans and grants. The Federal Government had already been compelled to set up a hurriedly improvised agency in each of the states for the purpose of stimulating the preparation of plans, for the checking and approval of those plans, and for the transmission of the plans to Washington. It is not improbable that this situation was in part responsible for the efforts of the central government to establish state planning in a more permanent form.

Furthermore, at the time when the Federal Government took the initiative, economic planning on the Russian model still played a large part in our thinking. It is therefore not improbable that the new state planning agencies were created in the hope that they might serve as adjuncts of the Federal activities in economic planning.

Experienced economic planners, however, were not available in our country. The large-scale industrial planners who had worked for private corporations were not infrequently in bad repute with the national government. For a variety of reasons, the theoretical students of economic planning were, as a rule, also disqualified for appointment to the newly created positions. As a result, city planners were called on to direct the activities of the state planning bodies.

Evolved from City Planning

We are now confronted by another question: What is city planning? In the cities, as in the states, the need for planning had made itself felt long before trained planners had become available. It became urgent first in the fields of water supply and sewage disposal. The municipal departments responsible for those basic services developed and applied the necessary techniques, and, as a rule, still exer-

cise control over them. In the larger cities, similarly, when problems of mass transportation arose, these also were assigned for solution to newly created departments.

Up to that time, the forerunners of the present generation of city planners had concentrated their efforts largely on the so-called amenities of urban living. While their dreams of the "city beautiful" had found few supporters, they had performed yeoman service in the development of parks, and in popularizing the concept of comprehensive planning. The new needs generated in all cities by the invention of the automobile, and in the larger cities by the development of facilities for mass transportation as well, gave the city planners their opportunity. They expanded their fields to include, in addition to parks, the problems involved in opening, widening, and laying out streets to relieve vehicular congestion; and in controlling, by the development of zoning, the tendency toward catastrophic shifts in urban land uses, which had grown in part out of the very circumstances which had given the planners their new opportunities, in part out of the economic effects of the new arteries for vehicular traffic which they themselves had planned.

As their prestige grew, the city planners were invited to extend their activities, from the central cities where their work had begun, to the suburbs—to the outlying fringes which were not yet urban, but earnestly hoped to be. Here, for the first time, they found virgin fields for the formulation of comprehensive plans, which started with the basic services of water supply and sewerage, and wound up with the city beautiful. If Ellis Island hadn't closed its doors, if the stork hadn't put into practice the current theories of limitation of output, and if our permanent high level of prosperity hadn't collapsed under us, there is no telling what might have happened.

In any event, this thumb-nail sketch gives an approximate idea of what city planning was when the advent of state planning opened the doors to wider opportunities. It was therefore almost inevitable that some, at least, of the erstwhile city planners, now turned state planners, should have dreamed of extending the benefits of urban living—modern plumbing, congestion, high bonded debt, and all—throughout the length and breadth of the state.

On the basis of this series of guesses, I have now arrived at a composite picture of state planning as it is; namely, city planning on a state-wide basis, enriched with a mild flavor of economic planning, and with the addition of certain elements such as flood control, reforestation, soil conservation, and rural zoning, in those states where studies in these fields had already gotten under way.

The Situation With Which State Planning Is Confronted

Before proceeding to speculate concerning state planning as it might be, I want to turn aside now to discuss the situations which exist, and with which state planning might be expected to deal.

In Suburban Areas

In this connection, I shall discuss first, in broad outline, the situation disclosed by my recent study under the auspices of the State Planning Council of the State of New York. The late Robert Whitten, a distinguished and wise city planner of long experience, and the state's first Director of State Planning, had devoted time and thought to the economics of subdivision for urban purposes. At his invitation, I undertook a study of the extent to which lands in the metropolitan areas of the state of New York had been subdivided for urban uses in advance of need; and of the

effects of that premature subdivision, both on the revenues and on the expenditures of the local governments involved.

The area included in the study comprised all or part of each of the four largest metropolitan regions in the state, namely, the New York, Buffalo, Rochester and Syracuse regions. Stated in another way, it included the areas of 8 cities, of 62 towns, and of the 50 villages which lie within those towns. By counts based on the assessment rolls, we found that those areas contained approximately a million and a half separately described parcels of taxable real estate. Of this number, slightly more than one-third consisted of pieces of vacant land. These vacant lands, however, were not evenly distributed among the municipalities. They concentrated most heavily in 35 cities and towns located in the metropolitan fringes. Of the 409,000 taxable parcels in those areas, two-thirds were vacant lots and lands.

We turned our attention next to the accumulated arrears of general and special taxes. Because of the labor involved, this portion of the study was completed for only 5 of the 8 cities and for only 47 of the 62 towns. This sample contained 530,000 taxable parcels, of which number almost 6 out of 10 were vacant. Of the improved properties, about one-seventh were in arrears; of the vacant lands, slightly more than one-half.

The total of the arrears analyzed, exclusive of penalties and interest, was in excess of $34,000,000. Of this sum, the vacant lands were responsible for more than two-thirds. Leaving out of account the cities with their large proportions of highly developed properties, and taking only the towns, the analyses disclosed that more than $18,000,000 of unpaid taxes were outstanding on their rolls; and that $16,000,000 of this sum had accumulated against 127,748 vacant lots.

In some of the towns, furthermore, the accumulated

arrears amounted to 4.3 times the current levy for the year 1934. In a portion of one of these towns, with a population of 8,115, there were 27,422 lots in the recorded subdivisions alone. Of these, 25,258 were vacant; and 20,828 of the vacant lots were in arrears. On many subdivisions in this and other areas, the accumulated arrears were already far in excess of the valuations at which the properties were carried on the rolls. The valuations, in turn, represented boom prices rather than sound current values.

Needless to say, the high volume of accumulated arrears in these areas consisted in large part of special levies which had been made to defray the cost of the sewers, water mains, and street pavements installed to serve the vacant lots. In one town, every dollar of outstanding indebtedness had been incurred to provide street improvements in one-twelfth of the town's area. In some of the new subdivisions located in this section of the town, every lot had remained vacant and every lot was in arrears.

It proved impossible to compile precise estimates of the increased costs of government which attended the premature subdivision of rural lands for urban purposes in the areas subjected to scrutiny. All in all, it is probably not far wide of the mark to say that in a handful of suburban towns alone, some $40,000,000 had been spent to provide unneeded street improvements along unneeded streets flanked by unneeded lots.

Inadequacy of City Planning in Suburban Areas

And now, let me invite your attention to another aspect of this strange situation. In practically all the suburban cities, towns, and villages which were included in the study, planning commissions and zoning boards had been established. In other words, the techniques which had evolved for the control of land use in urban centers had been applied

in practically all the suburban areas where premature subdivision, arrears on vacant lots, and expenditures for unneeded street improvements had been carried to the greatest lengths. If every city, town and village in the state of New York were to establish planning and zoning boards; and if every one of those new agencies were to exercise the powers delegated to it to the utmost, it would still be possible to subdivide every acre of privately owned land in this state into small building lots, and into the public streets necessary to serve those lots.

In Rural Areas

Outside the suburban areas, to which my own study was confined, closely analogous situations exist in state after state. In New York, the State College of Agriculture at Cornell University has been studying these situations systematically for more than twenty years. Robert Whitten, when he became the administrative head of the new state planning agency, was quick to see that these problems were also his own, and promptly offered his cooperation in expediting the studies.

It is characteristic of the situation in rural areas of this type that extensive areas of land suitable only for forestry or grazing have been cut up into the much smaller holdings suitable in size only for general farming. The local governments have expended borrowed money for rural roads and schools, to serve a scattered farming population foredoomed to failure. While population in these regions declines slowly, taxpaying capacity declines rapidly. Meanwhile, costs of government tend to remain stationary, or even to mount. As a consequence, pressure for state aid becomes acute, because local revenues soon fall to a level which is no longer adequate to maintain minimum standards in education and other essential services.

To illustrate: In 13 school districts in one county in New York, all located on the least productive classes of land, state aid constitutes 87 per cent of the total district revenues. Annual aids for education alone, exclusive of grants made for all other purposes, amount to almost 5 per cent of the estimated true value of all property in the districts. If the state were to apply these grants to the purchase of the individual farms, it would become the owner of all land and improvements in the 13 districts in slightly more than 20 years.[1] If the county aids made in the form of advances to the districts for uncollected local taxes had been taken into account in this computation, as well as the state aids for the maintenance of local roads, the estimated 20-year period would be materially shortened.

Suburban and Rural Examples Compared

Situations of this kind have one characteristic in common with those which we have found to exist in the fringes of the metropolitan areas. They lie just below a margin of economic use. The prevailing prices for lands suitable for the higher use are ten times or more as high per unit of area as those for the next lower economic use. In short, if a man will buy a tract of cut-over forest land and cut it up into shapes and sizes suitable for farming, and if he can find buyers for his farms, he can get rich almost overnight without working. Similarly, if a man can buy a farm or even a cow pasture and cut it up into city lots, when the market is right, he also stands a good chance of being able to spend his winters in Florida.

That is why in state after state, we find hundreds of thousands of acres of farm land cut up prematurely into

[1] New York State College of Agriculture, *Farm Economics No. 88*, February, 1935, p. 88; and Lane, Charles N.: *Submarginal Farm Lands in New York State*, Albany: N. Y. State Planning Board, 1935 (mim.), p. 18 and Table 31, p. 46.

city lots, and millions of acres of forest or pasture lands cut up into what purport to be farms.

If the trouble ended with the individual losses to those who pay out good money for a small piece of forest land on the assumption that it is a farm, or for a still smaller piece of farming land on the assumption that it is a site for an urban dwelling, the problem would be bad enough. But, unfortunately, it does not end there. The subdivision process in itself sets in motion certain inexorable forces. Under existing statutes, the local governments are deprived of all freedom of choice as to what they must do.

As soon as one or two families move out into the wilderness to their supposititious farms, the local government becomes obligated to provide them with roads and schools. As soon as a municipality accepts the dedication of the streets in a new subdivision, it becomes liable to suits for damages if it fails to maintain the streets and other urban facilities in proper condition for use.

In short, premature subdivision, whether for rural or urban purposes, compels a substantial increase in public expenditures. The very fact that no effective need existed for the premature subdivisions makes the increased revenues necessary for the support of the increased expenditures incollectible. As a consequence, taxpayers whose properties lie at some distance from the newly created blighted areas, who had no part in the transaction, and who would, under existing laws, have been powerless to prevent it, must now assume the added burden of retiring not only the bonds issued for public improvements which they need and use, but also those issued for other improvements which nobody needs and which nobody can afford to use. Furthermore, the taxpayers of the state as a whole are called on to extend financial aid to the local units of government in

which large areas have been blighted by subdivision for inappropriate uses.

In selecting for use as illustrations the problems created by the premature subdivision of lands for urban and rural uses, I have been guided by two considerations. In the first place, the areas affected are extensive and the results are easily visible. In the second place, many studies are already available for the purpose of documenting my conclusions.

On the other hand, while most of our land lies outside of cities when we measure it in acres, most of it lies within our cities when we measure it in dollars of market price, of taxable values, or of annual earning power. It is within the narrow confines of the cities themselves that the great problems of land use arise which perplex the planners, the financial officers, and the investors. Premature transitions from one use to another within small areas near the hearts of our great cities may imperil the stability of public and private investments which in magnitude make those of entire rural counties look insignificant. While the basic principles involved are identical with those discussed in the suburban and rural examples, their workings are masked by the complexities of the economic mechanisms through which they operate in urban centers.

The Situation Summarized

In a nutshell then, here is the strange situation by which the state planner is confronted. Surveying the scene in perspective from the mountain top to which he has been elevated, he sees dimly through the fogs of prejudice, ignorance, and immemorial custom, a landscape made up of mountain and plain; of hill and valley; of lake, stream, and seashore; of wilderness, forests, farms, and cities. He sees also broad bands laid waste, and made unproductive, not

by some cataclysm of nature, but by the activities of well-meaning men.

As he examines the landscape more intensively, he finds statutory obstacles which stand in the way of the rehabilitation of the blighted areas. Even as he gazes, he sees men engaged in acts, not criminal in themselves, which must lead inevitably to the creation of new blighted areas. He sees the men who do these things using the tools which he himself, in his earlier career as city planner, helped to forge. He sees these men hailed by the local chambers of commerce as great builders. He sees the operations of statutes which, in effect, compel local governments to subsidize the ruinous activities of these "developers" by providing them with the public improvements without which they could not hope to get out of their ventures with a profit. And when the developers are well out of the project, and only their victims remain, he sees humanitarians, perturbed by the thought that the sins of the fathers should be visited upon the children, persuade the legislature to grant continuing subsidies for education, health, welfare, and highway maintenance in the blighted areas.

It was Bishop Bossuet, I believe, who pointed out long ago that men always accomplish something else from what they set out to achieve. That shrewd observation finds support in this instance. The well-meant state-aids in regions of this kind do but little to relieve the acute poverty which grows inevitably out of the situation. Instead they merely insure that the unwholesome blight will persist.

As he continues his detached contemplation of the scene spread before him, he becomes aware that the Federal Government—presumably all-wise, all-powerful, and beneficent—has come to the aid of the state and local governments. He finds that Government now extending loans and grants for the purpose of making cities grow where only

corn can flourish, and corn grow where only trees or sage-brush can thrive. As a result, the existing blight in many areas is intensified, and further blight made inevitable.

The Task of the State Planner

What chance has a lone state planner to bring order out of the chaos which he sees around him when all these forces are arrayed against him? He can hardly say to the Federal Government, by whose largess he was elevated to his present position: "Stay your hand. You are only messing up the landscape." He can hardly go to the state government, which is reluctantly and in niggardly fashion beginning to make a little room for him in its own budget: "Stop this foolish waste of money in subsidizing the 'shoe-string' promoter who makes a profit by creating situations out of which human misery grows, because it only binds you to continuing subsidies to his victims."

Nor can he say: "Give me the power, and I will put a stop to this criminal waste both of men and of lands." If he is worth his salt, he has already learned that he could not stop it if he would, because he does not yet know enough to exercise such powers wisely. He may even have learned that it cannot be stopped on the state level, but must be eradicated on the local level where it originates.

What else is there for him to do? Well, for one thing, he can do what the late Robert Whitten was willing to do. In his new capacity as a state planner, he can take an objective view and study the bitter fruits which grew out of some of his own work as a city planner. If he studies long enough, he may be able to find out why identical plans produce excellent fruits on some soils, bitter fruits on others. He can delve into the existing large volume of material on the proper use of land which has been compiled by the agricultural economists, the foresters, and other specialists in

selected land uses. He can compare their findings and proposals with one another and with his own. When he does, he will learn, I believe, that many of the proposals of the several specialists, each working in his own narrow field, are incompatible with one another; and that only a small number will prove valid from the standpoint of the state as a whole. While he is doing that, he will be on the way to making himself a "generalist" in a field which, in common with many others, is cursed today by the sincere but misguided efforts of the narrow specialists.

I am optimist enough to believe that if he carries on relatively inexpensive work of this kind long enough and intelligently enough, he can find the key threads in the sadly tangled web of overlapping land use which will make its unraveling fairly easy. When that time comes, I think he will have learned that the planner's decalogue, which up to now has consisted too largely of "Thou shalt's," must include also a few thundering "Thou shalt not's." Some of these, strange to say, must be addressed to the state legislature. For example: Thou shalt neither require nor permit any unit of local government to install any public improvement which serves no purpose beyond providing land agents with "topics of eloquence." In his study of public debt, H. C. Adams indicated the need for such a prohibition half a century ago.[2]

If the time comes that the state planner, with the aid of a few carefully selected and well buttressed facts, can carry conviction to people and legislature alike on these and other points in the interrelated problems of land use and governmental powers, he will have gone far toward solving the problem of future local revenues. I happen to be one of those who believe that there is no area of land in the world

[2] Adams, H. C.: *Public Debts.* P. 353 ff.

which, if used for the highest and best use to which it is at the time adapted, will not automatically produce the revenues necessary to support those governmental expenditures which are needed under the circumstances. Because men are human and prone to err, they will not infrequently misjudge the highest and best use of which a given piece of land is capable. But today we impose the penalties for these errors in judgment not on those who made them, but on those who did not. Nay more, we subsidize at public expense the activities of those who, knowingly or not, persuade others to make such blunders. That, as I see it, is the unforgivable sin in local finance today.

When we correct it, and permit the reduction of local expenditures to the level which the needs growing out of the site justify, local revenues will take care of themselves. At the same time, much of the need for state aid for local services will disappear, because such state aid today serves a useful purpose chiefly in areas already blighted by the subsidized activities of land agents.

Here, then, we have a task to which the state planner can devote himself immediately with the means already at his disposal. But first he should jettison the disproportionately large whistle with which the Federal Government equipped his small craft at the time of launching. Like Mark Twain's famous steamboat, some of the newly created agencies have had to tie up to the river bank to get up steam again after every blast of the whistle. There is even reason to believe that one or two of those which have already vanished did so because they blew themselves right out of the water.

Calm and detached research does not go hand in hand with a fanfare of publicity. It is my belief that the few state planning agencies which have a chance to survive at

all will increase their chances by becoming self-effacingly useful rather than merely conspicuous.

If proof were needed, this final proposal reveals how hopelessly old-fashioned my approach to the entire subject has been.

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